(10)

No. 04-163

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In The
Supreme Court of the United States

LINDA LINGLE, GOVERNOR OF THE STATE OF HAWAII, and MARK J. BENNETT, ATTORNEY GENERAL OF THE STATE OF HAWAII,

Petitioners,

v.

CHEVRON USA, INC.,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

JOINT APPENDIX

SETH P. WAXMAN*
PAUL R.Q. WOLFSON
Special Deputy Attorneys General
WILMER CUTLER PICKERING HALE AND DORR LLP
2445 M Street, N.W.
Washington, D.C. 20037
(202) 663-6000
(202) 663-6363 (fax)
Counsel for Petitioners

ROBERT A. MITTELSTAEDT
CRAIG E. STEWART*
JONES DAY
555 California Street, 26th Floor
San Francisco, CA 94104
(415) 626-3939
(415) 875-5700 (fax)
Counsel for Respondent

**Counsel of Record*

[Additional Counsel Listed On Inside Cover]

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COCKLE LAW BRIEF PRINTING CO (800) 225-6964
OR CALL COLLECT (402) 342-2831

Additional Counsel for Petitioners:

ROBERT G. DREHER
JOHN D. ECHEVERRIA
Special Deputy Attorneys General
GEORGETOWN ENVIRONMENTAL LAW & POLICY INSTITUTE
GEORGETOWN UNIVERSITY LAW CENTER
600 New Jersey Ave., N.W.
Washington, D.C. 20001
(202) 662-9364
(202) 662-9005 (fax)

MARK J. BENNETT
Attorney General
MICHAEL L. MEANEY
Deputy Attorney General
OFFICE OF THE ATTORNEY GENERAL
425 Queen Street
Honolulu, Hawaii 96813
(808) 586-1188
(808) 586-1205 (fax)

Of Counsel for Respondent:

DONALD B. AYER
MICHAEL S. FRIED
ESTHER S. MCDONALD
JONES DAY
51 Louisiana Avenue, N.W.
Washington, D.C. 20001
(202) 879-3939
(202) 626-1700 (fax)

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RELEVANT DOCKET ENTRIES

U.S. District Court

U.S. District Court for the District of Hawaii (Hawaii)

Date	#	DOCKET ENTRY
7/21/97	1	COMPLAINT; exhibit "a"; summons (issued) (mm) [Entry date 07/25/97]
		* * *
7/25/97	5	FIRST AMENDED COMPLAINT[1-1] by plaintiff Chevron U.S.A. Inc.; exhibit "a"; summons (issued) (wn) [Entry date 07/28/97]
		* * *
9/8/97	12	ANSWER by defendant Benjamin J. Cayetano, defendant Margery S. Bronster to complaint filed on 7/21/97 and amended complaint filed on 7/25/97 [5-1]; certificate of service (wn)
		* * *
1/28/98	25	NOTICE OF MOTION and motion by plaintiff for partial summary judgment on second claim for relief; memorandum in support; certificate of service – set for 11:15 3/23/98 before Judge Alan C. Kay (tbf) [Entry date 01/29/98]
		* * *
7/30/98	34	NOTICE OF MOTION and motion by defendant Benjamin J. Cayetano, defendant Margery S. Bronster for summary judgment; memorandum in support of defts' motion and in opposition to pltf's motion for partial summary judgment on second claim for relief;

declaration of Keith B. Leffler; exhibit "1"; and certificate of service – FILED UNDER SEAL – set for 9:45 9/8/98 before Judge Alan C. Kay (mm)

* * *

7/30/98 37 STIPULATION of facts [25-1] [34-1] – on behalf of pltf (mm) [Entry date 07/31/98]

* * *

11/10/9847 ORDER RE: MOTIONS FOR SUMMARY JUDGMENT by Judge Alan C. Kay – [granting plaintiff's motion for summary judgment on second claim for relief [25-1]; denying defendants' motion for summary judgment [34-1]] (cc: all counsel) (wn)

12/22/9848 STIPULATION for partial dismissal without prejudice of Counts 1, 3, and 4 of the first amended complaint; ORDER – by Judge Alan C. Kay – on behalf of pltf (mm) [Entry date 12/29/98] [Edit date 01/08/99]

12/22/9849 JUDGMENT – [ordered, adjudged and decreed that: 1. pltf have jgm in its favor and against defts Cayetano and Bronster, on the 2nd claim for relief of 1st and compl, etc. 2. 1st, 3rd and 4th claims for relief are hereby dismissed; 3. Chevron shall recover its cost of suit incurred herein] -- by Judge Alan C. Kay – on behalf of pltf: terminating case (c: all counsel) (mm) [Entry date 01/08/99]

* * *

1/19/99 52 NOTICE OF APPEAL; representation statement – by defendant from Dist. Court decision, [49-2] – coa 99-15108 (cc: all counsel) (tbf) [Entry date 01/20/99] [Edit date 02/08/99]

* * *

11/15/0055 JUDGMENT – 9TH CCA vacated and remanded the Decision of the District Court [Appeal [52-1] – Judges' Nelson, Beezer, and Fletcher, Circuit Judges (cc: all counsel, Judge Alan C. Kay, mag Judge Francis I. Yamashita, CRD(s) – Dottie Miwa & Sadie Mukawa) (lg) [Entry date 11/20/00] [Edit date 11/20/00]

* * *

2/22/02 90 STIPULATION re: adoption of stipulation of facts for trial; exhibit a (byy)

2/22/02 91 DECLARATION of expert witness John Umbeck (byy) [Entry date 02/25/02]

2/25/02 92 Direct testimony by DECLARATION of expert witness Keith Leffler; exhibit 1; certificate of service – by defendant (byy) [Entry date 02/26/02]

2/26/02 93 EP: Non Jury Trial – Opening statement by the defendant.

* * *

3/25/02 99 EP: Further evidentiary hearing: plaintiff's witness: John Ombeck recalled by the court; defendant's witness: Keith Leffler recalled by the court; case is submitted (Ct Rptr: Debra Chun) JUDGE Judge Susan O. Mollway (byy)

3/29/02 100 FINDINGS of fact and conclusions of law and Order by Judge Susan O. Mollway (cc: all counsel) (byy)

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4/26/02 103 NOTICE OF APPEAL by defendant from Dist. Court decision [101-2] (cc: all counsel) – CA # 02-15867 (byy)

* * *

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JOHN R. MYRDAL
JEFFREY A. DAMASIEWICZ
Grosvenor Center, Mauka Tower
737 Bishop Street, Suite 2420
Honolulu, HI 96813
Telephone: (808) 599-5445

CASE BIGELOW & LOMBARDI
BRUCE C. BIGELOW
Grosvenor Center, Mauka Tower
737 Bishop Street, Suite 2600
Honolulu, HI 96813
Telephone: (808) 547-5400

Attorneys for Plaintiff
CHEVRON U.S.A. INC.

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF HAWAII

CHEVRON U.S.A. INC., a Pennsylvania Corporation, Plaintiff, vs. BENJAMIN J. CAYETANO, Governor of the State of Hawaii, MARGERY S. BRONSTER, Attorney General of the State of Hawaii, Defendants.	Civil No. 97-00933 ACK (Constitutionality of State Statute) FIRST AMENDED COMPLAINT; EXHIBIT "A"; SUMMONS

FIRST AMENDED COMPLAINT

(Filed Jul. 25, 1997)

Plaintiff CHEVRON U.S.A. INC. ("Chevron") alleges as follows:

PARTIES

1. Chevron is a Pennsylvania Corporation. Chevron builds, owns, leases, and operates service stations nationwide, including in the State of Hawaii.

2. Defendant Benjamin J. Cayetano is the Governor of the State of Hawaii (the "Governor") and is sued in that capacity. The Governor is charged by law with all executive action, including the ultimate responsibility for enforcing the laws of the State of Hawaii

3. Defendant Margery S. Bronster is the Attorney General of the State of Hawaii (the "Attorney General") and is sued in that capacity. The Attorney General is charged by law with the responsibility for enforcing the laws of the State of Hawaii.

JURISDICTION AND VENUE

4. This Court has jurisdiction over this action pursuant to 28 U.S.C. §§ 1331 and 1343. This action arises under Article 1 of the Constitution of the United States and the Fifth and Fourteenth Amendments to the Constitution of the United States. Chevron seeks declaratory relief pursuant to 28 U.S.C. §§ 2201 and 2202 and Rule 57 of the Federal Rules of Civil Procedure.

5. Venue is proper in this judicial district pursuant to 28 U.S.C. § 1391.

SUMMARY OF CLAIMS

6. On June 21, 1997, Hawaii enacted Act 257, a true and correct copy of which is attached hereto as Exhibit A. Act 257 severely restricts rents on service stations, and

imposes an arbitrary and unconstitutional cap on the lease rents that Chevron can charge its dealers for service stations built and owned by Chevron. Chevron brings this action because Act 257, on its face, violates 42 U.S.C. § 1983, constitutes an unlawful taking and violates Chevron's rights to due process and equal protection under the United States Constitution. Chevron seeks a declaration that the lease rent cap provisions contained in Act 257 are unconstitutional and unenforceable, and an injunction prohibiting the Governor and Attorney General from applying or enforcing those provisions against Chevron.

FACTS COMMON TO ALL CLAIMS

7. On or about January 23, 1997, H.B. 1451, entitled "A Bill for an Act Relating to the Petroleum Industry," was introduced in the House of Representatives. The early versions of H.B. 1451 did not contain any provision limiting the lease rent payable on service stations. H.B. 1451 originated in the House of Representatives, crossed over to the Senate, and became final in the Conference Committee. H.B. 1451 was signed into law by the Governor on June 21, 1997, as Act 257.

8. Chevron is informed and believes that, after the Senate hearing on H.B. 1451 had already been held, a proposed Senate Draft 1 was circulated to Chevron, among others. Chevron was given an opportunity to make written comments on H.B. 1451, but there was never a public hearing where Chevron had an opportunity to testify against the rent cap provisions contained in H.B. 1451.

9. Act 257 imposes an absolute cap on the lease rents that Chevron can charge its dealers, limiting that rent to 15 percent of a dealer's gross sales (other than gasoline

sales), and 15 percent of a dealer's gross profit from gasoline sales, plus a percentage increase equal to any ground rent increase. Act 257 contains no mechanism for reviewing, adjusting, or obtaining relief from the lease rent cap.

10. Chevron is informed and believes that the lease rent cap provisions contained Act 257 were specifically designed to prohibit implementation in Hawaii of Chevron's new nationwide dealer rental program that became effective in January 1997.

11. Service station dealers on the neighbor islands, who have the greatest profit margins, will benefit from the lease rent cap provisions contained in Act 257; dealers on Oahu will not benefit from those provisions and may be subject to having increased rents, which otherwise would have been reduced under Chevron's new rental program.

12. Chevron has been in business in Hawaii for over 100 years and has made substantial long-term investments in Hawaii and in Chevron's dealer distribution network.

13. Unlike some of its competitors, Chevron's distribution system in Hawaii is almost entirely dependent on its independent lessee-dealers to distribute its products. Chevron leases 64 service stations to dealers in Hawaii.

14. Under its lessee-dealer arrangement, Chevron purchases land or leases it from a third party. Chevron then makes the entire investment to build the service station and the related facilities on each location. Chevron has invested in excess of $55 million in its lessee-dealer service stations and related facilities in Hawaii. Chevron then leases the land and facilities to the dealer on a turn-key

basis. Chevron pays all taxes, maintenance and insurance, takes care of the underground tanks, and bears the risk of liability for fuel leaks and soil contamination. Chevron charges a monthly lease rent and the dealer markets Chevron products. The average investment by a dealer is minimal.

15. The term of the lease with a dealer is typically three years, although a dealer is given rights to renewal by the federal Petroleum Marketing Practices Act (15 U.S.C. § 2801 et seq.).

16. Because rents are an element of competition between oil companies, service station rents have historically been extremely low compared with other commercial real estate and compared with Chevron's expenses.

17. Under Chevron's dealer rental program in effect from 1984 through the end of 1996, Chevron determined dealer rents by estimating the gasoline volume the service station should do at competitive prices and applying a formula to determine a base "motor fuel facilities rent." Chevron also estimated the sales that it thought the dealer should make from the automotive repair facility or convenience store on the location and assessed a monthly rent of 10 percent of that estimate. The motor fuel facilities rent was subject to reduction because Chevron rebated five cents of that rent for each gallon of gasoline purchased by the dealer from Chevron in excess of a base gasoline volume set forth in the lease. The resulting rents were exceedingly low and did not cover Chevron's expenses relating to the stations, i.e., ground lease rents, real property taxes, ordinary maintenance, and depreciation. On a national basis, rents collected from dealers in 1995 covered only 56 percent of Chevron's occupancy costs.

18. The high cost of doing business Hawaii has made and continues to make the recovery of Chevron's expenses particularly difficult in Hawaii.

19. Over time, Chevron's former rental program tended to favor high margin neighbor island dealers over low margin Oahu dealers. The neighbor island dealers have less competition and are therefore able to charge higher retail or "street" prices, which result in higher profit margins for those dealers. The disparity in gross profit per gallon of gasoline between dealers on Oahu and the neighbor islands can reach as much as three times.

20. Effective January 1, 1997, Chevron implemented a new nationwide dealer rental program that restructured the manner in which Chevron calculated lease rates. The new program should allow Chevron to recover a larger percentage of its occupancy costs and, at the same time, keep rents competitive.

21. Under Chevron's new rental program, a dealer's rent is based on the dealer's actual sales and margins. As a result, the rent the dealer pays for the station will be more closely related to the value of that station to the dealer. Dealers whose stations produce greater revenues will pay larger rents and dealers with the lowest revenues will see their rents decline under the new program.

22. The motor fuel facilities rent under Chevron's new program is a percentage of the dealer's gross margin (total motor fuel volume multiplied by weighted average per gallon margin). There are three different percentage brackets applied on an incremental basis to the monthly gross margin on fuel. The rent is 18 percent on the portion up to $18,000; 32 percent on the portion between $18,000 and $28,000; and 38 percent on the portion over $28,000.

If the new rent results in an increase in the dealer's motor fuel facilities rent, only one-third of that increase would be payable during 1997, and only two-thirds would be payable during 1998. Automotive service bay rents are frozen at their prior level. For convenience stores and car washes, the rent is a sliding percentage of the dealer's monthly sales. The rent is 5 percent on the portion up to $5,000; 7 percent on the portion between $5,000 and $10,000; and 10 percent on the portion over $10,000.

23. Under Chevron's new rental program, a significant portion of Chevron dealers nationwide should see their motor fuel facilities rents decline.

24. Even with the rent increases under Chevron's new rental program, Chevron will not be recovering all of its expenses. When the new program has been fully implemented in the year 2000, Chevron estimates that it will be recovering only 75 percent of its occupancy costs nationwide, as opposed to the 56 percent it recovered in 1995.

25. During the month of April 1997, Chevron received a total of $338,832 in lease rent from its dealers in Hawaii. For that same month, Chevron's expenses relating to the stations, i.e., ground lease rents, real property taxes, ordinary maintenance, and depreciation, totaled $548,065 exceeding Chevron's rental income by $209,233. Chevron was able to recover amounts that were above its expenses on only 12 of the 64 stations it leases to dealers in Hawaii.

26. Under Chevron's new rental program, the projected lease rents for 22 Chevron dealers in Hawaii, based on April 1997 sales, would stay the same or be

decreased by as much as $2,900 per month. Twenty-four Chevron dealers in Hawaii would have their rents increased by a range of $36 per month to $1,183 per month. The remaining 18 Chevron dealers Hawaii would have their rents increased by a range of $1,459 per month to $12,930 per month. Of those 18 dealers, all but 2 are located on the neighbor islands where the dealers' profit margins are as much as three times those of Oahu dealers.

27. Under Chevron's new rental program, when fully implemented in the year 2000, Chevron's projected monthly lease rents in Hawaii, based on April 1997 sales, would increase, but would still fall approximately 11 percent short of Chevron's April 1997 expenses.

28. Many of Chevron's stations are over 30 years old and will require substantial capital improvements in order to remain competitive. The cost of renovating a station or tearing down the existing facilities and building a new station ranges from $800,000 to over $2,000,000.

29. Act 257 will prevent Chevron from implementing its new nationwide service station rental program in Hawaii.

30. The lease rent cap imposed by Act 257 prevents Chevron from charging rent sufficient to allow it to recover its expenses relating to its dealer operated stations and precludes any chance of earning any return on Chevron's significant investment in service stations leased to dealers in Hawaii.

31. The lease rent cap imposed by Act 257 primarily benefits a small group of neighbor island dealers who currently enjoy profit margins which are as much as three times more than the margins achieved by Chevron's Oahu

dealers. Under the cap, the most profitable dealers will receive a rent decrease and the Oahu dealers, with lower profit margins, may be subject to having increased rent, which otherwise would have been reduced under Chevron's new rental program.

32. Act 257 favors oil companies who elected not to invest in a dealer distribution network, but instead built company-operated stations. Those companies entered the market long after Chevron did and continue to expand at Chevron's expense. Act 257 gives those companies an unfair advantage in that they do not have many retail dealers and thus will not be forced to subsidize many dealer operations with below-market rents.

33. An actual controversy has arisen and now exists between plaintiff and defendants relative to their respective rights and duties herein alleged.

34. Defendants contend that plaintiff's rights have not been violated and that the lease rent cap provisions of Act 257 are enforceable and constitutional.

35. Plaintiff contends that its rights have been violated and that Act 257 the lease rent cap provisions of Act 257 are unenforceable and unconstitutional.

36. Plaintiff desires a declaration of its rights pursuant to Rule 57 of the Federal Rules of Civil Procedure, and 28 U.S.C. §§ 2201 and 2202. Such declaration is necessary and appropriate at this time because plaintiff has been irreparably injured and will continue to suffer irreparable injury until the lease rent cap provisions of Act 257 are declared to be unconstitutional and unenforceable.

37. Plaintiff will suffer immediate and irreparable injury if an injunction is not issued prohibiting defendants

from enforcing the lease rent cap provisions of Act 257. Plaintiff has no adequate remedy at law because, among other things, plaintiff could only secure legal relief through a multiplicity of separate lawsuits, filed each and every time one of the leases for one of the Chevron dealers in Hawaii comes up for renewal after the effective date of Act 257; the lease for rent cap provisions contained in Act 257 fail to authorize the State of Hawaii to relieve Chevron from the losses it will suffer; leases renewed after the effective date of Act 257 will result in an irretrievable loss to Chevron and an unwarranted benefit to certain dealers who renew their leases after that date.

FIRST CLAIM FOR RELIEF

(Deprivation of Constitutional Rights in Violation of 42 U.S.C. § 1983)

38. Plaintiff incorporates by reference each and every allegation contained in paragraphs 1 through 37 as though fully set forth herein.

39. As a direct result of defendants' actions, official policy, and course of conduct, defendants, under color of law, have deprived Chevron of rights, privileges and immunities secured by the United States Constitution in violation of 42 U.S.C. § 1983, as herein alleged.

SECOND CLAIM FOR RELIEF

(Unlawful Taking in Violation of the Fifth and Fourteenth Amendments of the United States Constitution)

40. Plaintiff incorporates by reference each and every allegation contained in paragraphs 1 through 37 and paragraph 39 as though fully set forth herein.

41. Act 257, on its face, effects an impermissible taking of Chevron's property in violation of the Fifth and Fourteenth Amendments of the United States Constitution.

42. Chevron is entitled to a just and reasonable rate of return on its investment. Act 257 systematically guarantees that Chevron will receive no return on its investment by freezing rents at a level that is lower than Chevron's expenses, resulting in a rent cap that is necessarily confiscatory.

43. The enactment of Act 257 denies Chevron the economically viable use of its property and does not substantially advance any legitimate state interest.

44. The rent cap imposed by Act 257 is arbitrary.

45. Act 257 indiscriminately and uniformly places a cap on the lease rent that Chevron may charge to its dealers in Hawaii.

46. Act 257 contains no mechanism for reviewing, adjusting, or obtaining relief from the lease rent cap to prevent confiscatory results.

47. In determining the maximum allowable rent, Act 257 contains no mechanism providing for any individualized consideration of any particular piece of property. Nothing in Act 257 allows for consideration of numerous unique factors, including the characteristics or market value of each piece of property, the risk associated with the asset, land values over time, the rate of development of surrounding areas, margins, or any other factors which may have an impact on the value of a particular lease or service station. Act 257 does not differentiate among dealers and does not allow for consideration of any unique

factors, including the profitability of a particular station to a particular dealer or the ability of a particular dealer to pay rent to Chevron.

48. Act 257 does not preclude the sale or conveyance of leases by service station dealers and specifically provides that "[n]othing in this section shall prohibit a dealer from selling a retail service station in any manner." The Federal Petroleum Marketing Practices Act essentially grants lessee-dealers tenure for the duration of the lessor's control over the underlying property. Thus, so long as Chevron chooses to be in business at the location leased to the dealer, the dealer is entitled to continue to operate the service station, absent certain limited grounds for termination. Dealers also have the right to assign their occupancy rights, and a thriving market exists for those rights. The right to be a Chevron dealer at a particular location (where the investment is entirely Chevron's) often changes hands in the marketplace for several hundred thousand dollars. The existing dealer at the time of the enactment of Act 257 is able to transfer its interest in the service station at a premium because of the low rent cap mandated by Act 257. The availability of the premium and the resulting transfer of wealth and value from Chevron to the dealer fails to advance any purported legislative purpose for which Act 257 was enacted, and results in an unlawful taking.

49. The lease rent cap provisions contained in Act 257 are not reasonably necessary to the effectuation of any substantial governmental purpose. There is no nexus between any purported legislative purpose of Act 257 and the means used to further any such purpose. There is no proportionality between the burdens imposed on Chevron

by Act 257 and the benefits accruing to service station dealers in Hawaii as a whole.

THIRD CLAIM FOR RELIEF

(Violation of Due Process Rights Under the Fifth and Fourteenth Amendments of the United States Constitution)

50. Plaintiff incorporates by reference each and every allegation contained in paragraphs 1 through 37, 39, and 41 through 49 as though fully set forth herein.

51. Act 257 violates Chevron's substantive due process rights under the Fifth and Fourteenth Amendments of the United States Constitution.

52. The lease rent cap provisions contained in Act 257 are arbitrary, discriminatory, capricious, unreasonable and irrelevant to any legitimate exercise of Hawaii's police powers.

53. Act 257 deprives Chevron of a fair and reasonable return on its investment. Among its other deficiencies, Act 257 denies Chevron any rent increases on account of capital improvements made prior to the enactment of Act 257 and limits the amount Chevron may recover on account of any improvements that may be made after the enactment of that statute.

FOURTH CLAIM FOR RELIEF

(Violation of Equal Protection Rights Under the Fourteenth Amendment of the United States Constitution)

54. Plaintiff incorporates by reference each and every allegation contained in paragraphs 1 through 37, 39, 41 through 49, and 51 through 53 as though fully set forth herein.

55. Act 257 violates Chevron's equal protection rights under the Fourteenth Amendment of the United Stats Constitution.

56. On its face, Act 257 unreasonably and arbitrarily reclassifies oil companies, who are subject to the lease rent cap provisions of Act 257, and other lessors and landowners who are not.

57. The lease rent cap provisions of Act 257 unreasonably and arbitrarily discriminate against companies, such as Chevron, that are heavily dependent on a dealer distribution network.

58. The classification scheme embodied in Act 257 is not rationally related to any legitimate state interest. The varying treatment of different groups is unrelated to the achievement of any legitimate purpose.

59. The enactment of Act 257 was prompted by and reflects impermissible animus and hostility toward a particular group.

WHEREFORE, Chevron prays for relief as follows:

(1) as to the First Claim for Relief, a declaration that (a) Act 257 deprives Chevron of its constitutional

rights in violation of 42 U.S.C. § 1983; and (b) the lease rent cap provisions contained in Act 257 may not be applied or enforced against Chevron;

(2) as to the Second Claim for Relief, a declaration that (a) Act 257, on its face, effects an impermissible taking of Chevron's property in violation of the Fifth and Fourteenth Amendments of the United States Constitution; and 9b) the lease rent cap provisions contained in Act 257 may not be applied or enforced against Chevron;

(3) as to the Third Claim for Relief, a declaration that (a) Act 257 violates Chevron's substantive due process rights under the Fifth and Fourteenth Amendments of the United States Constitution; and (b) the lease rent cap provisions contained in Act 257 may not be applied or enforced against Chevron;

(4) as to the Fourth Claim for Relief, a declaration that (a) Act 257 violates Chevron's equal protection rights under the Fourteenth Amendment of the United States Constitution; and (b) the lease rent cap provisions contained in Act 257 may not be applied or enforced against Chevron;

(5) as to all Claims for Relief, an injunction prohibiting defendants from applying or enforcing the lease rent cap provisions contained in Act 257 against Chevron;

(6) an award of attorneys' fees and costs; and

(7) an award of such other and further relief as the Court may deem just and proper.

DATED: Honolulu, Hawaii, 7/24/97.

/s/ John R. Myrdal
JOHN R. MYRDAL
JEFFREY A. DAMASIEWICZ

CASE BIGELOW & LOMBARDI
BRUCE C. BIGELOW

Attorneys for Plaintiff
CHEVRON U.S.A. INC.

[Exhibit "A" (Act 257) and Summons not reprinted in this Appendix.]

MARGERY S. BRONSTER
Attorney General of Hawaii

DEBORAH DAY EMERSON
TED GAMBLE CLAUSE
Deputy Attorneys General
Department of the Attorney General, State of Hawaii
425 Queen Street
Honolulu, Hawaii 96813
Telephone: (808) 586-1180
Facsimile: (808) 586-1205

Attorneys for Defendants

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF HAWAII

CHEVRON U.S.A. INC., a Pennsylvania Corporation, Plaintiff, vs. BENJAMIN J. CAYETANO, Governor of the State of Hawaii, MARGERY S. BRONSTER, Attorney General of the State of Hawaii, Defendants.	) CIVIL NO. 97-00933 ACK (Constitutionality of State Statute) DEFENDANTS BENJAMIN J. CAYETANO AND MARGERY S. BRONSTER'S ANSWER TO THE COMPLAINT FILED ON 7/21/97 AND AMENDED ON 7/25/97; CERTIFICATE OF SERVICE

DEFENDANTS BENJAMIN J. CAYETANO AND MARGERY S. BRONSTER'S ANSWER TO THE COMPLAINT FILED ON 7/21/97 AND AMENDED ON 7/25/97

(Filed Sep. 8, 1997)

Defendants BENJAMIN J. CAYETANO, Governor of the State of Hawaii, and MARGERY S. BRONSTER,

Attorney General of Hawaii, by its undersigned attorneys, answer the First Amennded Complaint as follows:

1. Defendants admit the allegations of paragraph 1.

2. Defendants admit the allegations of paragraph 2.

3. Defendants admit the allegations of paragraph 3.

4. Defendants deny the allegations of paragraph 4.

5. Defendants admit the allegations of paragraph 5.

6. Defendants admit the first and last sentences in paragraph 6. Defendants deny the other allegations of paragraph 6.

7. Defendants admit the allegations of paragraph 7.

8. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 8.

9. Defendants deny the allegations in paragraph 9.

10. Defendants are without knowledge or information sufficient to form a belief as to the truth of Chevron's allegations in paragraph 10 of what it is informed or what it believes. Defendants deny the other allegations of paragraph 10.

11. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 11.

12. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 12.

13. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 13.

14. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 14.

15. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 15, except that the federal Petroleum Marketing Practices Act and the cases applying it speak for themselves.

16. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 16.

17. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 17.

18. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 18.

19. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 19.

20. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 20.

21. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 21.

22. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 22.

23. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 23.

24. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 24.

25. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 25.

26. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 26.

27. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 27.

28. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 28.

29. Defendants deny the allegations in paragraph 29.

30. Defendants deny the allegations in paragraph 30.

31. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 31.

32. Defendants deny the allegations of paragraph 32.

33. Defendants deny the allegations of paragraph 33.

34. As to paragraph 34, Defendants deny that they have made any contentions herein except as set out in this answer, including all affirmative defenses.

35. Defendants deny Plaintiff's contentions in paragraph 35.

36. Defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations in paragraph 36 of Plaintiff's desires. Defendants deny the other allegations of paragraph 36.

37. Defendants deny the allegations in paragraph 37.

38. With respect to paragraph 38, Defendants incorporate its answers to paragraphs 1 through 37.

39. Defendants deny the allegations of paragraph 39.

40. With respect to paragraph 40, Defendants incorporate its answers to paragraphs 1 through 37 and 39.

41. Defendants deny the allegations of paragraph 41.

42. Defendants deny the allegations of paragraph 42.

43. Defendants deny the allegations of paragraph 43.

44. Defendants deny the allegations of paragraph 44.

45. Defendants deny the allegations of paragraph 45.

46. Defendants deny the allegations of paragraph 46.

47. As to Plaintiff's allegations of the effect of Act 257, Act 257 speaks for itself. Defendants deny the other allegations of paragraph 47.

48. As to Plaintiff's allegations of the meaning and effect of Act 257 and the federal Petroleum Marketing Practices Act, the acts speak for themselves. Defendants deny the other allegations of paragraph 48 except that the Defendants are without knowledge or information sufficient to form a belief as to the truth of the fifth and sixth sentences of paragraph 48.

49. Defendants deny the allegations of paragraph 49.

50. As to paragraph 50, Defendants incorporate their answers to paragraphs 1-37, 39, and 41-49.

51. Defendants deny the allegations of paragraph 51.

52. Defendants deny the allegations of paragraph 52.

53. Defendants deny the allegations of paragraph 53.

54. As to paragraph 54, Defendants incorporate their answers to paragraphs 1-37, 39, 41-49, and 51-53.

55. Defendants deny the allegations of paragraph 55.

56. Defendants deny the allegations of paragraph 56.

57. Defendants deny the allegations of paragraph 57.

58. Defendants deny the allegations of paragraph 58.

59. Defendants deny the allegations of paragraph 59.

First affirmative defense: Plaintiff fails to state a claim on which relief can be granted.

Second affirmative defense: Plaintiff's claims are barred by the Eleventh Amendment.

Third affirmative defense: The court does not have subject matter jurisdiction because there is no case or controversy.

Fourth affirmative defense: The court does not have subject matter jurisdiction because the Plaintiff has adequate remedies at law.

Fifth affirmative defense: Plaintiff has failed to join indispensable parties.

Sixth affirmative defense: The court is obligated to abstain under the rule of *Railroad Commission of Texas v. Pullman*, 312 U.S. 496 (1941).

Seventh affirmative defense: Plaintiff does not have standing.

Eighth affirmative defense: Plaintiff's claims are barred by superseding cause.

Ninth affirmative defense: Plaintiff's claims are not ripe.

Tenth affirmative defense: The court should certify questions about the application of Act 257 to the Supreme Court of Hawaii.

Eleventh affirmative defense: Plaintiff's claims are barred by Plaintiff's unclean hands.

WHEREFORE, Defendants pray

A. That Plaintiff's requests for relief be denied and that the complaint be dismissed with prejudice.

B. That Defendants be awarded their attorneys fees and costs.

C. That Defendants be awarded such other relief as is just and proper.

DATED: Honolulu, Hawaii, September 8, 1997.

STATE OF HAWAII

/s/ [Illegible]
TED GAMBLE CLAUSE
Deputy Attorney General

/s/ Deborah Day Emerson
DEBORAH DAY EMERSON
Deputy Attorney General

Attorneys for Defendants

[Certificate Of Service Omitted In Printing]

VERNER, LIIPFERT, BERNHARD,
McPHERSON AND HAND

JOHN R. MYRDAL
JEFFREY A. DAMASIEWIZC
745 Fort Street, Suite 600
Honolulu, Hawaii 96813
Telephone No. (808) 566-0999

PILLSBURY MADISON & SUTRO LLP

REGINALD D. STEER
ROBERT C. PHELPS
235 Montgomery Street
San Francisco, California 94120
Telephone: (415) 983-1000

Attorneys for Plaintiff
CHEVRON U.S.A. INC.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

CHEVRON U.S.A. INC., a Pennsylvania Corporation, Plaintiff, vs. BENJAMIN J. CAYETANO, Governor of the State of Hawaii; MARGERY S. BRONSTER, Attorney General of the State of Hawaii, Defendants.	) Civil No. 97-00933 ACK) (Constitutionality of State Statute))) JUDGMENT)) (Filed Dec. 22, 1998)

JUDGMENT

On consideration of the opinion of this court made and entered in this cause on November 10, 1998, and for the reasons stated herein,

It is hereby *ORDERED, ADJUDGED* AND *DECREED* that:

1. Plaintiff Chevron U.S.A. Inc. have judgment in its favor and against defendants Benjamin J. Cayetano, Governor of the State of Hawaii and Margery S. Bronster, Attorney General of the State of Hawaii, on the Second Claim for Relief of the first amended complaint. The Court declares that (a) Section 3(c)(2) of Act 257, on its face, effects an impermissible taking of Chevron's property in violation of the Fifth and Fourteenth Amendments of the United States Constitution; and (b) defendant Bronster in her capacity as Attorney General of the State of Hawaii and all others authorized by law to enforce section 3(c)(2) of Act 257, and all those acting as agents or employees of the State of Hawaii be, and each is hereby, enjoined from applying or enforcing section 3(c)(2) of Act 257 against Chevron.

2. Chevron having agreed to proceed on the second claim for relief of the first amended complaint and not to pursue relief under any other claim alleged therein, the first, third and fourth claims for relief are hereby dismissed.

3. Chevron shall recover its cost of suit incurred herein.

Dated: Honolulu, Hawaii, Dec. 22, 1998.

/s/ Alan C. Kay
Alan C. Kay
United States District Judge

STANTON CLAY CHAPMAN CRUMPTON & IWAMURA

JOHN R. MYRDAL #1269
TRED R. EYERLY #5641
Amfac Tower, Suite 2100
700 Bishop Street
Honolulu, Hawaii 96813
Telephone: (808) 535-8400
Facsimile: (808) 535-8444

PILLSBURY WINTHROP LLP

ROBERT A. MITTELSTAEDT
CAROLINE N. MITCHELL
LAUREL T. PAUL
50 Fremont Street
Post Office Box 7880
San Francisco, CA 94120-7880
Telephone: (415) 983-1000
Facsimile: (415) 983-1200

Attorneys for Plaintiff
CHEVRON U.S.A. INC.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

CHEVRON U.S.A., INC., a Pennsylvania Corporation, Plaintiff, vs. BENJAMIN J. CAYETANO, Governor of the State of Hawaii; EARL I. ANZAI, Attorney General of the State of Hawaii, Defendants.	CIVIL NO. 97-00933 SOM (Constitutionality of State Statute) **STIPULATION RE: ADOPTION OF STIPULATION OF FACTS FOR TRIAL; EXHIBIT A** (Filed Feb. 22, 2002) Trial Date: February 26, 2002 Time: 9:00 a.m.

STIPULATION RE: ADOPTION OF STIPULATION OF FACTS FOR TRIAL

Plaintiff CHEVRON U.S.A. and Defendants BENJAMIN J. CAYETANO, Governor of the State of Hawaii, and EARL I. ANZAI, Attorney General of the State of Hawaii, by and through their attorneys of record, hereby stipulate that the Stipulation of Facts attached hereto as Exhibit A is adopted for purposes of trial.

DATED: 2/20/02 /s/ Tred R. Eyerly
JOHN R. MYRDAL
TRED R. EYERLY
Attorneys for Plaintiff

DATED: 2/20/02 /s/ Charles H. Price
JAMES E.T. KOSHIBA
CHARLES A. PRICE
Attorneys for Defendants

Exhibit A

VERNER, LIIPFERT, BERNHARD,
McPHERSON AND HAND

JOHN R. MYRDAL
JEFFREY A. DAMASIEWICZ
745 Fort Street, Suite 600
Honolulu, Hawaii 96813
Telephone No. (808) 566-0999

PILLSBURY MADISON & SUTRO LLP

REGINALD D. STEER
ROBERT C. PHELPS
235 Montgomery Street
San Francisco, California 94120
Telephone: (415) 983-1000

Attorneys for Plaintiff
CHEVRON U.S A. INC.

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF HAWAII

CHEVRON U.S.A. INC., a Pennsylvania Corporation, Plaintiff, vs. BENJAMIN J. CAYETANO, Governor of the State of Hawaii; MARGERY S. BRONSTER, Attorney General of the State of Hawaii, Defendants.	Civil No. 97-00933 ACK (Constitutionality of State Statute) STIPULATION OF FACTS (Filed Jul. 30, 1998) Trial Date: February 2, 1999

STIPULATION OF FACTS

Preamble

Plaintiff, Chevron U.S.A. Inc. ("Chevron"), and defendants, Benjamin J. Cayetano and Margery S. Bronster in their representative capacities as Governor and Attorney General of the State of Hawaii respectively ("defendants"), by and through their attorneys of record, hereby submit the following Stipulation of Facts in connection with Chevron's Motion for Partial Summary Judgment on Second Claim for Relief and Defendants' Motion for Summary Judgment. The sole purpose of this Stipulation of Facts is to deem each of the following statements, whether considered a factual statement, a legal conclusion, or a combination of both, to be undisputed as between the parties. In entering into this stipulation, the parties: 1) reserve the right to object to the relevance of any of the following statements; 2) reserve the right to claim that other statements, which may remain disputed, are relevant to the pending motions for summary judgment, but agree to limit any such statements to those which may be submitted by the parties' respective expert witnesses; and 3) reserve the right to object on any grounds to any or all additional statements submitted by the other party.

Proposed Stipulation of Facts

1. On June 21, 1997, the State of Hawaii enacted Act 257.

2. Effective January 1, 1997, Chevron implemented a new nationwide dealer rental program that restructured the manner in which Chevron calculates rents paid under service station leases.

3. The lease rent cap provisions contained in Act 257 prohibit complete implementation in Hawaii of the rent rates specified in Chevron's new dealer rental program.

4. Under Chevron's rental program (as it would have operated in Hawaii absent Act 257) the "motor fuel facilities rent" is a percentage of the dealer's gross margin on motor fuel sales (total motor fuel sales volume multiplied by weighted average per gallon margin). There are three different percentage brackets applied on an incremental basis to the monthly gross margin on fuel. The rent is 18 percent on the portion up to $18,000; 32 percent on the portion between $18,000 and $28,000; and 38 percent on the portion over $28,000. Act 257 does not allow Chevron to charge the "motor fuel facilities" rent that it otherwise would have charged. Act 257 does not have a direct impact on non-motor fuel facilities rent under Chevron's rental program because the 15 percent cap is greater than what Chevron would have otherwise charged as non-motor fuel facilities rent without Act 257.

5. Pending the outcome of this litigation, Chevron amended all new dealer leases in Hawaii. For leases signed after June 20, 1997, rents (starting with September 1997) have been and will be established at the maximum amount permitted by Act 257. If the rent under Act 257 (counting both motor fuel facilities rent and non-motor fuel facilities rent) exceeds the rent which would have been charged under Chevron's new rental program by more than $500 in any particular month, Chevron will waive the difference for that month. Thus, no dealer will be required to pay more than $500 more in any month than the dealer would have been required to pay under Chevron's new rental program. The $500 maximum sum is intended as an administrative fee to help defer Chevron's

additional cost of administering a new and different rental program for Hawaii, particularly the cost of monitoring automotive service bay sales. If Act 257 is held to be invalid, the lessee-dealer will be required to pay Chevron the difference between the amount that otherwise would have been paid under Chevron's new rental program and any lesser amount actually paid by the dealer under Act 257. These facts are reflected in Table 1, attached hereto.

6. Chevron estimates that, after all lessee dealer agreements in Hawaii are renewed under Act 257, the Act will preclude Chevron from charging the rent it otherwise would have charged for 11 of Chevron's 64 lessee dealer stations in Hawaii. These facts are reflected in Table 1, attached hereto. In addition, the rental provisions of Act 257 cause Chevron to require dealers to account for automotive service bay sales which it otherwise would not do and to lower the motor fuel facilities rents for all lessee dealers in Hawaii.

7. Under its lessee-dealer arrangement, Chevron purchases land or leases it from a third party, makes the entire investment to build the service station and to build the related facilities on each location, and leases the land and facilities to the dealer on a turn-key basis.

8. Chevron incurs ongoing expenses attributable to the lessee-dealer rental property, such as ground lease rents, real property taxes, ordinary maintenance (subject to the terms and conditions of the dealer lease), and the accounting expense entry of "depreciation."

9. Under a dealer lease, Chevron charges the lessee-dealer a monthly lease rent. Under a supply contract, the lessee-dealer markets Chevron motor fuels, which the

determined by Chevron. Chevron does not enter into a dealer lease unless the dealer simultaneously executes a supply contract with Chevron. Copies of the lease and supply contract Chevron would use under the new program are attached.

10. Chevron has invested more than $58,000,000 in its current lessee-dealer service stations and related facilities in Hawaii. The present book value of those same service stations and related facilities is more than $37,000,000.

11. Table 1 is an accurate summary of the projected rents for each Chevron lessee-dealer station in Hawaii for the twelve month period from January 1, 1998 through December 31, 1998.

12. The maximum rents Chevron projects it could receive under the statutory scheme imposed by Act 257, when applied to all Chevron dealer leases in Hawaii, total $6,126,646 during the 12-month period from January 1, 1998 through December 31, 1998.

13. Chevron's projected expenses during the 12-month period from January 1, 1998 to December 31, 1998 for its lessee-dealer stations in Hawaii, i.e., ground lease rents, real property taxes, ordinary maintenance, depreciation, and other direct station expenses total $6,292,855, exceeding Chevron's projected rental income by $166,209.

14. Chevron would not invest in lessee-dealer stations except for its expectation that Chevron gasoline will be sold at such stations.

15. Chevron requires each lessee-dealer to market Chevron-branded gasoline purchased directly from Chevron

as a condition of Chevron's entering a lease with the dealer.

16. Although any dealer who installs his own pumps and tanks is legally free to purchase non-Chevron gasoline, each Chevron lessee dealer in Hawaii currently obtains (and has obtained for at least the last 10 years) its supply of gasoline exclusively from Chevron.

17. Chevron recovers its expenses and investment costs of lessee dealer stations (e.g., ground-lease rent, real property taxes, ordinary maintenance, and depreciation) in Hawaii and throughout the United States through two principal revenue streams – rental revenue and earnings on Chevron gasoline sold through the stations.

18. Chevron's evaluation of the return on investment from the development of new lessee-dealer stations in Hawaii and throughout the United States includes in the return a measure of the expected earnings from the sale of Chevron-branded gasoline at the station.

19. Chevron has provided incentive payments to dealers that own their stations in return for the dealer's agreement to market Chevron-branded gasoline. These incentives typically take one of three forms: (a) a discount off the normal lessee-dealer gasoline price, (b) an upfront cash advance typically used for improvements to the station, which is amortized on a cents per gallon basis over a fixed period (usually 10 years), or (c) a combination of (a) and (b). Since 1990, the size of such upfront payments (under (b) above) in Hawaii have been as follows:

$ 18,000
$ 20,000
$110,000
$110,000

$248,654.12
$300,000
$400,000

The first two listed were funds for branding only (i.e., signs, painting, etc.).

20. It is economically rational for Chevron to provide such incentives because Chevron expects to recover the incentive payments via earnings from sales of Chevron-branded gasoline.

21. Including Chevron's earnings from gasoline sold by Chevron at its lessee dealer stations in Hawaii, Chevron has earned in the past and anticipates that it will earn in the future, at the rent levels allowed by Act 257, a return that satisfies any Constitutional standards on its investment in lessee dealer stations in Hawaii.

22. Chevron has positive net earnings from its sales of gasoline to Hawaii resellers.

23. In the aggregate, Chevron has not within the last 20 years recovered its expenses relating to dealer stations (ground lease rents, real property taxes, ordinary maintenance, and depreciation) in Hawaii or elsewhere in the United States from dealer station rents.

24. Chevron's dealer leases run for a three-year term, unless Chevron's underlying ground lease expires in less than three years, in which case the dealer lease expires at the same time as the underlying ground lease.

25. So long as Chevron chooses to be in business at the location leased to the dealer, the dealer is entitled, under the federal Petroleum Marketing Practices Act, 15 U.S.C. §§ 2801-2806, to continue to operate the service

station, absent certain limited grounds for termination and nonrenewal set forth in the Act. Under 15 U.S.C. § 2802(b)(3)(A), Chevron can make changes in the dealer lease (including the rent) and supply contract at the time of each 3-year renewal as long as those changes are proposed "in good faith and in the normal course of business" and not "for the purpose of converting the leased marketing premises to operation by employees or agents of the franchisor for the benefit of the franchisor or otherwise preventing renewal of the franchise relationship."

26. Chevron's lessee-dealer lease and supply contracts permit the lessees to assign their occupancy rights, subject to obtaining Chevron's written consent and paying a transfer fee set by Chevron before assigning a lease or any interest therein.

27. Neither Chevron's dealer lease nor Chevron's dealer supply contract limits the price at which a lessee dealer can sell, convey, or otherwise transfer his or her occupancy rights.

28. Act 257 allows the sale, conveyance or other transfer of leases by service station dealers.

29. Act 257 does not limit the price at which a lessee dealer can sell, convey or otherwise transfer his or her interest in a service station lease.

30. Act 257 does not prohibit Chevron from refusing to consent to a transfer of a dealer station by a dealer lessee so long as Chevron acts in good faith as defined in HRS § 486H-1.

31. Act 257 does not prohibit Chevron from requiring any amendment of its dealer leases at the time of each

3-year renewal except with respect to the amount of rent Chevron can charge the dealer-lessee, so long as Chevron acts in good faith as defined in HRS § 486H-1.

32. Since 1992, each of the following Chevron lessee dealers sold his or her interest in the gasoline station ("lessee dealer station") to another individual:

Station	Date of Sale	Transfer Price	Average Monthly Gallons Prior Year	Estimated Monthly APC Sales
91970	Oct. 94	$250,000	74,841	$40,000
93053	Mar. 95	$100,000	94,078	$45,000
93053	Dec. 93	$100,000	87,683	$40,000
93183	Jun. 93	$95,000	96,517	$20,000
93215	Sep. 95	$80,000	131,015	$25,000
95318	Jan. 93	$180,000	124,801	$22,000
97303	Jan. 94	$140,000	148,617	$35,000
98132	Jan. 92	$500,000	172,235	$50,000
98242	Aug. 97	$200,000	261,463	$55,000
98691	Nov. 93	$348,000	163,565	$20,000
99070	Aug. 94	$90,000	103,619	$22,000
99080	Jan. 92	$165,000	48,121[1]	$15,000
99425	Oct. 94	$360,000	123,834	$20,000
99723	Apr. 94	$400,000	196,897	$40,000

[1] 1991 volume data is not available. This figure represents the average monthly sales for the 1990 calendar year.

33. According to the information reasonably available to Chevron, since 1992, 14 Chevron lessee dealers in Hawaii have assigned their leases and supply agreements to third persons. Chevron expects that further assignments will occur in the future.

34. The existing dealer at the time of the enactment of Act 257 may be able to sell his leasehold at a premium that derives from the value of the dealer's leasehold interest, given the reduced rent imposed by Act 257, assuming Chevron does not object in good faith when the selling dealer seeks Chevron's consent to the assignment.

35. Assuming everything else remains equal, the market value of the lessee-dealer leasehold reasonably could be expected to increase as the amount of the rent payable decreases.

36. The earnings available to the Chevron lessee dealer from the sale of gasoline at a particular Chevron lessee dealer station in Hawaii depend upon a number of factors including the dealer's expertise and business acumen, the location of the station, the features of the station, the location of competitors' stations, the pricing at competitors' stations, the rent paid by the lessee dealer, other costs of the station, and the price paid by the dealer to Chevron for gasoline.

37. The competitive conditions facing retail gasoline station dealers vary from dealer to dealer.

38. The market shares for gasoline produced or refined in Hawaii during 1997 were approximately: Chevron 60% and BHP 40%.

39. The market shares by brand to retail outlets for the period ending May 30, 1997 were approximately:

	Chevron	Shell	Texaco	Tosco	BHP	Other
Oahu	30.7%	12.9%	12.5%	15.8%	14.4%	13.6%
Hawaii	29.5%	10.8%	11.4%	21.4%	8.0%	18.9%
Maui	20.7%	23.8%	19.0%	17.8%	11.2%	7.5%
Kauai	28.3%	43.0%	N/A	10.5%	N/A	18.2%

40. Act 257 does not apply to any dealer lease in effect on August 1, 1997.

41. Chevron has not sought compensation in the Hawaii state courts for inverse condemnation relating to Act 257.

Dated: Honolulu, Hawaii _____.

/s/ John R. Myrdal
JOHN R. MYRDAL
JEFFREY A. DAMASIEWICZ
VERNER, LIIPFERT,
BERNHARD, McPHERSON
AND HAND
Attorneys for Plaintiff
CHEVRON U.S.A. INC.

/s/ Ted G. Clause
DEBORAH DAY EMERSON
TED GAMBLE CLAUSE
Attorneys for Defendants

[Exhibits Other Than Table 1 Omitted]

Chevron Products Company
Hawaii 3-Party - Annual Projections

Table 1

Station	Island	Estimated Annual Expenses	Estimated Sales			Estimated Annual Rent - under Act 257	Estimated Annual Rent - under Chevron's new rent program	Estimated Annual Rent - Revised Hawaii Program	
			Fuel Volume (Gal/Month)	Fuel Margin (cpg)	Non-Fuel Sales ($/Month)			Basis	
90258	Oahu	99,994	69,620	7.9	43,000	87,297	42,294	48,294	Chevron + $500/mo.
90371	Oahu	70,765	88,811	7.9	42,000	88,225	61,999	67,999	Chevron + $500/mo.
90464	Oahu	110,132	93,280	7.9	45,000	94,260	38,703	44,703	Chevron + $500/mo.
90903	Maui	78,873	132,423	23.1	35,000	118,136	122,855	118,136	Act 257
91053	Oahu	129,853	226,601	7.9	35,000	95,212	72,918	78,918	Chevron + $500/mo.
91217	Hawaii	39,368	69,795	27.6	30,000	88,615	59,997	65,997	Chevron + $500/mo.
91266	Maui	136,997	113,163	23.1	80,000	191,117	158,869	164,869	Chevron + $500/mo.
91317	Hawaii	75,801	124,043	27.6	55,000	160,519	163,255	160,519	Act 257
91507	Oahu	77,843	134,554	7.9	25,000	64,127	46,409	52,409	Chevron + $500/mo.
91524	Oahu	60,367	85,875	7.9	50,000	102,208	49,636	55,636	Chevron + $500/mo.
91571	Maui	52,376	114,860	23.1	40,000	119,823	117,737	119,823	Act 257
91919	Oahu	172,954	124,080	7.9	30,000	71,638	53,158	59,158	Chevron + $500/mo.
91964	Oahu	52,190	107,810	7.9	20,000	51,326	46,993	51,326	Act 257
91970	Oahu	95,813	57,807	7.9	40,000	80,217	52,312	58,312	Chevron + $500/mo.
92619	Maui	45,167	81,971	23.1	45,000	115,130	101,882	107,882	Chevron + $500/mo.
92866	Kauai	87,832	213,326	15.5	30,000	113,555	125,835	113,555	Act 257
92890	Maui	150,287	106,230	23.1	20,000	80,230	103,491	80,230	Act 257
92896	Maui	65,777	74,838	23.1	30,000	85,160	70,022	76,022	Chevron + $500/mo.
92912	Hawaii	62,400	144,366	27.6	35,000	134,599	158,233	134,599	Act 257
93053	Oahu	148,311	88,473	7.9	40,000	84,577	57,145	63,145	Chevron + $500/mo.
93183	Oahu	67,961	124,631	7.9	20,000	53,717	38,845	44,845	Chevron + $500/mo.
93186	Oahu	94,977	87,109	7.9	40,000	84,383	56,930	62,930	Chevron + $500/mo.
93207	Oahu	154,999	169,283	7.9	60,000	132,064	98,883	99,883	Chevron + $500/mo.
93555	Oahu	89,800	66,118	7.9	25,000	54,399	44,022	50,022	Chevron + $500/mo.
93568	Oahu	141,312	111,493	7.9	60,000	123,849	84,774	90,774	Chevron + $500/mo.
93719	Oahu	48,476	66,018	7.9	30,000	63,385	44,846	50,846	Chevron + $500/mo.
93778	Oahu	92,113	66,638	7.9	15,000	36,473	32,104	36,473	Act 257
93871	Kauai	66,034	107,630	15.5	40,000	102,047	65,442	71,442	Chevron + $500/mo.
93875	Oahu	116,929	166,247	7.9	65,000	140,633	75,405	81,405	Chevron + $500/mo.

Chevron Products Company
Hawaii 3-Party - Annual Projections

Table 1

Station	Island	Estimated Annual Expenses	Estimated Sales			Estimated Annual Rent - under Act 257	Estimated Annual Rent - under Chevron's new rent program	Estimated Annual Rent - Revised Hawaii Program	
			Fuel Volume (Gal/Month)	Fuel Margin (cpg)	Non-Fuel Sales ($/Month)				Basis
93970	Oahu	205,056	278,751	7.9	40,000	111,625	91,072	97,072	Chevron + $500/mo.
94109	Oahu	78,801	55,829	7.9	25,000	52,936	44,800	50,800	Chevron + $500/mo.
94204	Oahu	116,455	129,466	7.9	50,000	108,404	67,207	73,207	Chevron + $500/mo.
94682	Maui	127,485	91,083	23.1	20,000	73,924	84,241	73,924	Act 257
94871	Oahu	206,995	214,171	7.9	100,000	210,445	148,959	154,959	Chevron + $500/mo.
94888	Oahu	109,379	102,388	7.9	5,000	23,555	19,139	23,555	Act 257
95023	Oahu	106,351	181,683	7.9	40,000	97,827	76,638	77,838	Chevron + $500/mo.
95054	Molokai	66,571	98,731	35.8	70,000	189,661	169,372	175,372	Chevron + $500/mo.
95318	Oahu	59,346	154,589	7.9	20,000	57,975	43,567	49,567	Chevron + $500/mo.
95570	Oahu	49,450	62,752	7.9	25,000	53,920	42,291	48,291	Chevron + $500/mo.
95592	Oahu	62,001	112,421	7.9	15,000	42,981	39,320	42,981	Act 257
95683	Oahu	98,516	82,697	7.9	35,000	74,756	39,435	45,435	Chevron + $500/mo.
95812	Oahu	84,536	102,383	7.9	40,000	86,554	53,338	59,338	Chevron + $500/mo.
96005	Hawaii	84,516	180,062	27.6	40,000	161,302	214,105	161,302	Act 257
96247	Oahu	53,855	108,818	7.9	40,000	87,474	78,352	84,352	Chevron + $500/mo.
96728	Oahu	137,946	87,924	7.9	45,000	93,499	43,259	49,259	Chevron + $500/mo.
96737	Oahu	70,870	42,299	7.9	10,000	24,013	43,867	24,013	Act 257
97186	Oahu	169,699	86,333	7.9	60,000	120,272	68,964	74,964	Chevron + $500/mo.
97303	Oahu	177,697	123,743	7.9	11,000	37,391	46,505	37,391	Act 257
97442	Kauai	59,929	123,322	15.5	25,000	79,428	65,565	71,565	Chevron + $500/mo.
97458	Oahu	34,757	65,231	7.9	20,000	45,273	31,882	37,882	Chevron + $500/mo.
97619	Kauai	111,051	90,805	15.5	45,000	106,350	75,983	81,983	Chevron + $500/mo.
97970	Oahu	145,826	112,302	7.9	30,000	69,964	48,901	54,901	Chevron + $500/mo.
98132	Hawaii	93,005	136,151	27.6	70,000	193,524	164,936	170,936	Chevron + $500/mo.
98242	Oahu	182,611	267,841	7.9	50,000	128,075	100,015	106,015	Chevron + $500/mo.
98584	Oahu	74,195	121,303	7.9	35,000	80,244	56,320	62,320	Chevron + $500/mo.
98673	Oahu	122,052	192,312	7.9	40,000	99,338	73,513	79,513	Chevron + $500/mo.
98691	Hawaii	148,089	166,516	27.6	40,000	149,624	185,166	149,624	Act 257
98823	Oahu	49,752	133,807	7.9	35,000	82,021	66,691	72,691	Chevron + $500/mo.

Chevron Products Company
Hawaii 3-Party - Annual Projections

Table 1

Station	Island	Estimated Annual Expenses	Estimated Sales			Estimated Annual Rent - under Act 257	Estimated Annual Rent - under Chevron's new rent program	Estimated Annual Rent - Revised Hawaii Program	
			Fuel Volume (Gal/Month)	Fuel Margin (cpg)	Non-Fuel Sales ($/Month)				Basis
99070	Oahu	37,554	101,942	7.9	30,000	68,491	40,669	46,669	Chevron + $500/mo.
99080	Oahu	119,543	163,505	7.9	30,000	77,243	56,972	62,972	Chevron + $500/mo.
99248	Oahu	52,299	78,284	7.9	35,000	74,128	47,139	53,139	Chevron + $500/mo.
99425	Oahu	203,296	139,261	7.9	25,000	64,796	41,751	47,751	Chevron + $500/mo.
99691	Hawaii	67,557	70,003	27.6	40,000	106,718	85,089	91,089	Chevron + $500/mo.
99723	Hawaii	50,113	155,245	27.6	55,000	175,994	189,604	175,994	Act 257
Total		6,292,855	7,621,044			6,126,646	4,989,521	5,078,716	

STANTON CLAY CHAPMAN
CRUMPTON & IWAMURA
JOHN R. MYRDAL #1269
TRED R. EVERLY #5641
Amfac Tower, Suite 2100
700 Bishop Street
Honolulu, HI 96813
Telephone: (808) 535-8400
Facsimile: (808) 535-8444

PILLSBURY WINTHROP LLP
ROBERT A. MITTELSTAEDT
50 Fremont Street
Post Office Box 7880
San Francisco, CA 94120-7880
Telephone: (415) 983-1000
Facsimile: (415) 983-1200

Attorneys for Plaintiff
CHEVRON U.S.A., INC.

IN THE UNITED STAKES DISTRICT COURT

FOR THE DISTRICT OF HAWAII

CHEVRON U.S.A., INC., a Pennsylvania Corporation, Plaintiff, vs. BENJAMIN J. CAYETANO, Governor of the State of Hawaii, et al. Defendants.	No. 97-00933 SOM DECLARATION OF EXPERT WITNESS JOHN UMBECK Trial Date: February 26, 2002 Judge: Hon. Susan Mollway (Filed Feb. 22, 2002)

I, John R. Umbeck, declare under penalty of perjury under the laws of the State of Hawaii that my direct

testimony is attached to this declaration. It is true and correct to the best of my knowledge.

Executed in West Lafayette, Indiana on February 21, 2002.

/s/ John Umbeck
John Umbeck

DIRECT TESTIMONY OF JOHN R. UMBECK

QUALIFICATIONS

1. I am Professor of Economics in the Krannert Graduate School of Management at Purdue University. I received a Bachelor of Arts in economics from Occidental College in 1967, a Master of Arts in economics from UCLA in 1968 and a Ph.D. in economics from the University of Washington in 1976. I have been teaching economics since 1968. From 1975 on, I have been teaching at Purdue University, where I was promoted to Full Professor in 1988. I have received several awards and honors for my academic work and have published extensively in the field of economics. These honors, publications and other professional experiences are listed in my curriculum vitae, which is attached hereto as Exhibit 1.

2. My major areas of concentration are private contract, industrial organization and regulation/antitrust economics. I have been certified as an economic expert in these areas in state, federal and international courts. I have done extensive research, publishing and consulting in widely diverse industries such as banking and credit, health care, insurance, publishing, alcohol, agriculture, air traffic control and crime enforcement. In addition, I have done numerous research projects related specifically to

various aspects of the U.S. petroleum industry. These projects have been published in academic journals; presented to various state and federal government agencies, such as the EPA, DOJ and the DOE; presented in testimony before committees of the U.S. Senate, House of Representatives, and several state government agencies; used in litigation involving allegations of contract violations and antitrust violations; or used by various oil companies for internal decision making. These projects are listed in Exhibit 1.

3. Within the petroleum industry, one of my principal areas of investigation is the area of forced contractual change. When the government has proposed or enacted laws that would force changes in private contracts, I have analyzed the predicted or actual consequences of these changes. Examples include laws that would prohibit oil companies and private individuals from contracting for salaried employment in retail gasoline stations, laws that would prohibit oil companies and private individuals from contracting for exclusive supply arrangements and laws that would prohibit oil companies and private individuals from contracting for prices on petroleum products.

4. In forming the opinions expressed here, I have reviewed Act 257, Chevron's complaint and Summary Judgment Motion and the accompanying materials, including the Declaration of Keith B. Leffler submitted on behalf of the defendants. I have relied on my academic training, research and experience in economics and the petroleum industry.

SUMMARY OF OPINIONS

5. I have found the following:

a. Act 257 will penalize Chevron and its lessee-dealers, reducing their viability in Hawaii;

b. Act 257 will penalize consumers because it can be expected to lead to higher retail gasoline prices;

c. Act 257 will not benefit future lessee-dealers who purchase leases from current dealers – they will pay incumbent dealers a premium reflecting any value of the rent control to the dealer;

d. Act 257 will not permit Chevron to charge a service station rent that will allow it to earn a competitive (reasonable) return on its investments in station assets.

BACKGROUND

6. Oil companies have a choice of methods for selling gasoline to the public. They can sell it directly at stations that they own and operate themselves – "company operated stations." They can sell it to individuals who own and operate their own stations and who obtain gasoline from the oil company of their choice – "open" or "two party" dealers. Or they can sell it to individuals who lease and operate stations owned by the oil companies – "lessee" or "three party" dealers. The rent control statute applies only to the latter category – the only ones who have a lease arrangement with the oil companies.

7. For its lessee stations, Chevron purchases the land or leases it from a third party and makes the entire

investment to build the service station and related facilities. Chevron then leases the finished station to a dealer. Chevron incurs ongoing expense associated with the stations, including ground lease rents, real property taxes, Ordinary maintenance and the like.

8. Lessee dealers have two contracts with Chevron. Under the dealer lease, the dealer agrees to pay a monthly rent to Chevron. Under the supply contract, the dealer agrees to buy Chevron-branded gasoline from Chevron at a price unilaterally set by Chevron. (The dealer then sets the retail price at which he resells gasoline to motorists). Historically, the rents charged by Chevron have been insufficient to recover its costs of operating the stations. Instead, Chevron recovers its expenses not only through rent but also through the price of gasoline and other charges.

9. I understand that the parties have stipulated that:

a. Lessee-dealers are permitted to assign their occupancy or franchise rights to others for monetary consideration, subject to Chevron's approval;

b. From 1992 to 1998, 14 Chevron dealers in Hawaii assigned their rights to others, for a range of $80,000 to $500,000;

c. Act 257 does not limit the price at which a lessee dealer can sell, convey or otherwise transfer his or her interest in a service station lease;

d. Assuming everything else remains equal, the market value of the lessee-dealer leasehold reasonably could be expected to increase

as the amount of the rent payable decreases; and

e. As a matter of basic economics, the dealers may be able to sell their leasehold interest at a premium reflecting the rent control.

10. I understand that Act 257 capped the rent that oil companies could charge their dealers at 15% of the dealer's profit on gasoline sales and 15% of the dealer's gross sales on products other than gasoline, plus (where applicable) a percentage increase equal to any increase that the oil company is required to pay on its ground lease. This contrasts with the Chevron rent program which establishes motor fuel rent at a sliding scale of 18% to 38% of the dealers' gross margin on gasoline and other fuel sales.

THE LEASE RENT CAP WILL NOT LESSEN THE ALLEGED ADVERSE COMPETITIVE IMPACTS FROM HIGH CONCENTRATION

11. A well accepted axiom in economics is that individual decision makers try to maximize the net present value of their assets. Indeed, it is this effort to maximize the value of assets that drives the capitalist system. The opportunity to increase their wealth provides the incentive for suppliers to take risks, use valuable resources and sacrifice personal comfort and leisure to produce and sell products. The same opportunity to increase wealth provides incentives for buyers to shop around and buy products through contracts. Thus, oil companies will strive to create contracts with their lessee dealers that generate a revenue flow that will maximize the net present value of their land, stations, gasoline and other assets, subject to the constraint that the dealers can

choose not to agree to the contracts. Similarly, dealers will strive to find contracts with oil companies that will maximize the net present value of their resources, subject to the constraint that the oil companies can choose not to agree to the contracts.

12. Once the contract has been agreed upon, a contractual change, forced upon both contracting parties by an outside third party, will generally reduce the net present value of the revenue stream, reducing the value of the assets to one or both parties.

THE LEASE RENT CAP CAN BE EXPECTED TO LEAD TO FEWER RETAIL GAS STATIONS

13. Virtually every textbook in economics agrees that rent control, to the extent that it reduces the net return to the supplier, will reduce the incentive of the supplier to produce and supply the controlled product. Here, basic economic theory predicts that oil companies will produce fewer gas stations, because the market will force oil companies to reallocate their resources to more productive alternative uses, in locations where they are not penalized for building and renting retail stations. To the extent that rent control benefits dealers, it disadvantages the oil company. And it is the oil company's economics that determines whether it will continue to invest in dealer stations.

THE NUMBER OF SERVICE STATIONS PROVIDED BY OIL COMPANIES WILL BE REDUCED

14. From this simple principle, we can derive several conclusions. First, there is no basis for a claim that this rent control (Act 257) will "lessen the anticompetitive

impact of high concentration." Concentration, as typically measured by economists, is simply a measure of the percent of a market currently being supplied by different sellers. If each oil company equally reduces its number of gasoline stations by the same percent, the brand concentration levels will be unchanged; there will just be fewer stations. Beyond that statement, regardless of how we calculate market concentration, the Hawaiian rent control law will have an indeterminate effect on concentration levels.

15. While the effect on concentration is indeterminate, it is clear that the service station rent control penalizes the suppliers of lessee-dealer stations, reduces the net present value of their rental revenue and reduces their incentive to build new stations or maintain old ones. As a result, the total number of stations in the market will be smaller. Consumers will have fewer choices of stations over time.

THE LEASE RENT CAP WILL NOT MAINTAIN THE PRESENCE OF LESSEE-DEALERS IN HAWAII; IT WILL REDUCE THEIR NUMBERS

16. The rent control will not serve to maintain the number of lessee dealers in Hawaii. First, as shown above, by reducing the net present value of the revenue stream derived from rent and penalizing the supplier of stations, rent control will, in time, reduce the total number of stations that would otherwise exist in Hawaii. Oil companies have a number of alternatives from which to choose in deciding how to operate a service station. For example, aside from leasing a station to a dealer, an oil company can put salaried employees in the station. Or it can sell the station outright and then contract to be the gasoline

supplier. It can also lease the convenience store or car wash to a dealer and keep the gasoline islands and pumps, paying the dealer a commission to sell the gasoline. Oil companies can co-brand with fast food chains and pay the franchisee for the right to sell gasoline at their restaurants. They can also get out of the station owning business entirely and contract with a jobber to supply the gasoline. The jobber in turn may operate his stations with salaried employees, commission or consignment franchisees or lessee dealers, or use any one of a number of alternative contractual arrangements.

17. The Hawaii rent control law singles out lessee-dealer stations and penalizes them relative to the other alternatives. In addition to ultimately resulting in a smaller number of stations in total, the rent control will alter the gains and costs of various modes of station operation, forcing the oil companies to choose fewer of the lessee-dealers and more of the other alternatives. Thus, the rent control will lead to fewer dealers at the retail level, and competition at the retail level will not be enhanced.

THERE IS NO BENEFICIAL IMPACT ON GASOLINE PRICES IN HAWAII AS A RESULT OF THE RENT CONTROL

18. The rent cap will actually cause retail gasoline prices to increase, in the short run and the long run.

19. Because rent control will reduce the incentive for oil companies to build new stations and maintain old ones, it will lead, in the long run, to fewer stations. According to the State's own logic (see Leffler Decl., footnote 5), "this

will increase the demand facing the surviving dealers and motivate and allow them to raise price."

20. The short run effect on price is more subtle. Dr. Leffler acknowledges that "A wholesaler of gasoline can impact the economic viability of its dealers through two variables, the rent and the wholesale gasoline price it charges." When rent control reduces the net present value of the revenue stream from station rents, oil companies can recoup at least part of this lost value by increasing the wholesale price of gasoline. Indeed, the market wholesale price is likely to increase to the extent that oil companies are impacted by rent control. To the extent that rent is directly related to gasoline sales and can be translated to a cents per gallon figure, a forced reduction in rent which is offset by an equal increase in wholesale gasoline price will not lead the dealer to change his retail gasoline price. That is because his overall costs on a per gallon basis will remain the same. In this example, the rent control will not promote the State's interest in lower gasoline prices. Indeed, even in this example, because the split between rent and the wholesale gasoline price is different from the split considered optimal by the company, the altered split can be expected to lead to inefficiencies and therefore to higher retail prices.

21. If, on the other hand, a dealer raises his retail prices because his wholesale gasoline price has increased, either stations in competition with the dealer will raise their prices and the dealer will sell about the same volume as before or, if competition does not respond immediately, customers may switch to a lower-priced dealer. The increase in demand for the other dealer, in turn, will lead him to raise prices. So one way or the other, consumers

will end up paying more for gasoline in the vicinity of stations that are impacted by the rent control.

22. Contrary to Dr. Leffler's assertion, the possibility that Chevron's sales volume will decrease if it increases its wholesale price will not prevent Chevron from raising its price to offset rent reduction. This is because its losses from the rent reduction without any increase in the gasoline price will be greater than if it recoups part of the rent reduction by raising its gasoline price even if it loses some volume. Plus, if competitors raise their prices as well, the loss in volume will be smaller if not negligible.

RICHARDSON PREMIUM TRANSFER ISSUE

23. The incumbent dealer will be able to capture any premium created by the rent control when selling his dealership rights to a new dealer. The premium will reflect the difference between the incumbent dealer's expected market rent and his lower rent as a result of Act 257, discounted by the appropriate interest rate for the expected life of the station.

24. The State's arguments do not disprove this fundamental point. Beginning on page 8 of his declaration, paragraph 12, Dr. Leffler states that even if the current lessee dealer captures all of the net present value of the rent reduction when he transfers his lease to a "new" lessee-dealer, the new lessee-dealer will still benefit from the rent control. The source of this benefit, according to Dr. Leffler, comes from " . . . lower monthly rent payments (that) reduce the new dealer's cost of *continued* operation." According to Dr. Leffler, this reduction in the new dealer's operating cost comes from the fact that he paid the original dealer a lease purchase price that included a lump

sum payment equal to the present value of the expected reduction in the continued operating cost. Once paid, the future operating costs of the dealer, in cash flow, will be lower by the amount of the ongoing rent reduction. Dr. Leffler claims that this will help the new dealer by allowing him to remain in business, when and if gasoline revenues decline, longer than he would absent the rent reduction. There are several things wrong with Dr. Leffler's analysis.

25. Even if there were some increase in the original dealer's net earnings and they were fully captured by the original dealer in the lease transfer, as Dr. Leffler assumes in his example, the new dealer would not have lower operating costs. This is because the new dealer, like the original, has the opportunity to resell the lease and capitalize the present value of the lower rent. If the market conditions have not changed from the time of the first transfer, the new dealer can resell the lease for exactly the same price as he paid. Because the opportunity exists for the new dealer to resell the lease, the rent reduction is no longer a fixed cost. It may be true that his required operating "cash flow" is lower, but his full operating costs must now include the interest on the money the new dealer could have if he resold the lease. This will be exactly equal to the reduction in the monthly rent. Dr. Leffler acknowledges the fact that if the new dealer borrowed the money to buy the lease there would be no reduction in the new dealer's operating costs. However, he is confused when he suggests that the lessee-dealer could use the station as collateral on the loan. The station and the land belong to the oil company and cannot be used by the dealer to secure his loan.

26. Even if we grant Dr. Leffler all of the elements of his example, his conclusion still does not follow from his assumptions. The reason is that the decision on whether or not to stop operating the station is not entirely the dealer's. The new lessee-dealer can certainly quit operating the station, but the oil company that owns the station chooses when to remove it from the market. When, as Dr. Leffler assumes, " . . . adverse events . . . " occur that reduce the dealer's net income, the amount he pays to the oil company will fall. When this payment fails to cover the economic cost to the oil company, it can shut the station down. A rent reduction, to the extent that it exists and is fully captured by the original dealer, does not give the new dealer any advantage in terms of staying in the market longer. In fact, because it is the oil company's decision whether or not to keep the station open, and to the extent that the rent the oil company can earn is constrained by the law, the station will actually be closed or converted from lessee-dealer earlier than it would be without the law.

27. It is true that a supplier's decision whether to close a station is affected by Federal law, the Petroleum Marketing Practice Act (PMPA). For example, the oil company may have to first offer the station to the existing dealer for sale. Of course, if the dealer purchases the station he will no longer be a lessee dealer but will now own the assets and bear the full economic cost of ownership and operation. In any event, as I understand it, the PMPA does not require a supplier to continue leasing a station that is uneconomic due to rent control or other reasons.

28. Dr. Leffler argues that rent reductions will not be fully capitalized in subsequent transfer prices. He offers

several reasons for his conclusion. He claims that part of the rent reduction will be passed on to the consumers of gasoline through lower retail prices. I have already shown this argument to be false. The rent reduction will have the effect of increasing retail prices in both short and long run. Consumers will be hurt by the rent control law.

29. Dr. Leffler claims that because other factors, which might change in unforeseeable ways, affect the gross profit margins of dealers, it is unlikely that anyone could accurately forecast the effect of the rent control law. He goes on to state that we might expect them, on average, to correctly forecast but that would imply that half of the new buyers would undercapitalize the benefits and these individuals would be "direct beneficiaries of Act 257." There are three points to note concerning this part of Dr. Leffler's assertions. Economic theory does deal with future uncertainties that arise out of imperfect information. These models predict that "expected" future benefits will be capitalized in the transfer price of assets. Economic theory does not deny that future returns to dealers will depend upon a variety of factors other than just the law or Chevron's rent policy. Holding these other things constant, we predict that expected future returns will be captured in the lease transfer. If, after the lease transfer, other things change, it does not alter the fact that the lease transfer captured the expected gains from the rent control. For example the new dealer could get run over by a careless driver and killed the day after buying his lease. In this case his net present value would instantly fall to zero, due to an unforeseeable change in circumstances, but it does not mean he incorrectly capitalized the expected rent control gains at the time of the lease purchase.

30. Most importantly, Dr. Leffler's statement that half the dealers would pay a premium less than the actual present value of the rent reduction ignores the fact that half would pay a premium greater than the actual present value. These dealers would presumably be harmed by Act 257. However, on average, the expected net benefits to future dealers would be zero, even in Dr. Leffler's analysis.

31. The fact that there are relatively few lease transfers in any given year does not imply a lack of competition. Furthermore, full capture of benefits does not require a large number of sellers. Contrary to Dr. Leffler's assertion, the number of actual lease transfers tells us nothing about the competitive nature of the market. At any point in time there may be many individuals who are interested in buying a station lease. These individuals may be bidding against each other for just one lease, like an auction with many "potential" buyers. Competition among these buyers will drive the price of the lease up. Will this competition drive the lease price up to the point where the original dealer captures all of the future benefits? The original dealer has the choice of staying in the station and earning any of the benefits that might have come to him because of the rent control. He will only sell the station if the offer price has a present value equal to the present value of his expected income stream. This suggests that the lease sale price will capture the original dealer's expected future value.

32. Dr. Leffler's assertion in paragraph 19 of his declaration that buyers and sellers may have different expectations of the future effects of the rent control, so that a bargaining process that depends on "negotiation skills" results, is just a restatement of the argument he makes earlier. Dr. Leffler believes that on average expectations of

buyers and sellers will be correct. Similarly, in the absence of any reliable way to predict or measure the distribution of "negotiation skills," we would expect them to be randomly distributed among buyers and sellers. Therefore, on average we would expect the final lease transfer price to capture the expected future benefits of the rent control. While half of the transfers would undercapitalize the true gains, half would overcapitalize the true gains and, on average, no new dealer would benefit from the rent cap.

THE RENT CONTROL PREVENTS CHEVRON FROM CHARGING A STATION RENT THAT WILL COVER ITS ECONOMIC COSTS OF OWNERSHIP AND OPERATION AT THE MARGINAL STATION

33. In paragraph 22, Dr. Leffler recognizes that Chevron's rental revenues are not sufficient to cover even its accounting costs of station ownership and operation. One obvious implication of this is that if gasoline profits decline to the point where they only yield a "reasonable" return on gasoline costs, then the rent control would not allow a "reasonable" return on the station property. For Dr. Leffler, the "reasonableness" of the legal service station rent is entirely dependent on the profitability of another product, gasoline.

34. Dr. Leffler then devotes a good deal of time demonstrating that Chevron's combined gasoline revenue and rent generates a **total** return to Chevron on its investments that more than covers the full economic cost of the stations. However, his entire discussion is irrelevant as it misses the fundamental economic issue involved in this case. Virtually every economics textbook informs us that optimization decisions are made at the margin and

not in total. In other words, how much net revenue Chevron makes on all of its retail station assets in Hawaii is really not at issue. Rather it is the net revenue it makes on a marginal or extra station that matters. To illustrate, suppose that Chevron has two retail stations in Hawaii. The first station generates $1 million dollars in net revenue (revenue minus the full economic cost of the station) while the second station generates an extra $10 in net revenue. Dr. Leffler would point out that the two stations combined have earned $1,000,010 in net earnings for Chevron and that a small reduction in rental revenue from the rent control law will not significantly effect Chevron's ability to cover its station costs. However, notice that if the rent control reduces the revenue flow at the second (marginal) station by more than $10, Chevron would optimize its asset holdings by closing the second station. Total returns to assets are irrelevant to this issue. Marginal returns are the key. At this margin, the incentive to open new stations or maintain existing stations will be reduced by the rent control. There will be fewer stations in the future, less choice and higher prices for consumers.

CONCLUSIONS

35. If we are to believe Dr. Leffler, the Hawaiian rent control law is truly a remarkable piece of legislation. According to Dr. Leffler, so far, Chevron has actually earned more total rent than it would have without the law; consumers benefited through lower retail prices; current lessee-dealers had an increase in their net profits and future dealers benefited by purchasing the leases at prices below the true market value. It sounds too good to be true. More complete economic analysis suggests that Dr. Leffler is

incorrect on virtually every point. Fundamental economics indicate that Chevron will in fact be penalized for operating lessee-dealer stations; consumers will pay higher prices for their gasoline; lessee-dealers will not see an increase in their net income, rather they will lose as the incentive to maintain a lessee-dealer network will be reduced; future dealers will be disadvantaged as there will be fewer lessee-dealer stations built and maintained by the oil companies as they switch into alternative modes of station operation and reallocate their resources to other areas where the laws do not penalize them for leasing to dealers.

[Certificate Of Service Omitted In Printing]

EXHIBIT 1

RESUME

Name:	John R. Urbeck
Address:	Department of Economics 458 Krannert Building Purdue University West Lafayette IN 47907-1310
Telephone:	Purdue Office 765-494-4447 Home Office 765-463-0857 Fax 765-463-0385
Date of Birth:	April 21, 1945

Education

BA. Occidental College, Los Angeles, California, 1967
M.A. University of California, Los Angeles, 1968
Ph.D. University of Washington, Seattle, 1976

Academic Experience

1968-1971 Assistant Professor of Economics, California State Polytechnic College, San Luis Obispo, California

1971-1974 Teaching and Research Assistant, University of Washington, Seattle Washington

1974-1975 Assistant Professor of Economics, Virginia Polytechnic Institute and State University, Blacksburg, Virginia

1975-1981 Assistant Professor of Economics, Purdue University, West Lafayette, Indiana

1981-1988 Associate Professor of Economics, Purdue University, West Lafayette, Indiana

1988- Professor of Economics, Purdue University, West Lafayette, Indiana

Awards and Grants

Research Awards

Best Research Article of the Year, Published by the Western Economic Association, 1981, awarded for "Might Makes Rights: A Theory of the Formation and Initial Distribution of Property Rights."

Best Research Article of the Year, Published by the Western Economic Association, 1991, Runner-up awarded for "Screening and Signaling in Credit Markets," co-authored.

Research Honors

I have appeared on or my research has been cited in the following: N.B.C. National News, A.B.C. National News, The Wall Street Journal, Good Morning America, Forbes Magazine, New York Times, CNN News, Time Magazine, Readers Digest and Paul Harvey News.

My earlier research on the formation of property rights was selected for a collection of articles in honor of the Nobel Prize winner, Ronald Coase.

Research Grants

National Science Foundation – for the Investigation of Contracts, S.N.S. Cheung, Principal Investigator, 1974.

Foundation for Research in Economics and Education – for the Study of Contracts, 1975.

Krannert Graduate School of Management – for the Study of Contracts, summer, 1976, 1977, 1980, 1988, 1989.

Federal Trade Commission – for the Study of the Holder-In-Due-Course, through the Credit Research Center, 1979.

Carthage Foundation – for the Study of Contract Incentives of Federal Data Collectors, 1982 (with J. Barron).

Carthage Foundation – for the Study of Insurance Claim Filing Patterns, 1982-1983. Arthur Andersen – for the Study of Drunk Driving Laws, summer, 1987.

Krannert Graduate School of Management – for the Study of Petroleum Marketing Practices, summer 1990, 1991.

Krannert Graduate School of Management – for the Study of Predatory Pricing with Financial Markets 1992

Teaching Awards

Outstanding Teacher of the Year (teaching undergraduates) 1985 winner. School of Business, Purdue University.

Outstanding Teacher – G.E. Executive Masters Program, (teaching executives) 1985, Purdue University.

Outstanding Teacher of the Year (teaching undergraduates) 1970 runner-up. California Slate Polytechnic College, San Luis Obispo, CA.

Outstanding Teacher of the Year (teaching undergraduates) 1973 runner-up. University of Washington, Seattle, WA.

Outstanding Teacher of the Year (teaching undergraduates) 1976, 1979, 1980, 1981, 1982,

1983, 1994, runner-up. School of Business, Purdue University, West Lafayette, IN.

Outstanding Teacher of the Year (teaching graduates) 1978 runner-up. School of Business, Purdue University.

Research

Publications

Books

A Theory of Property Rights, Iowa State University Press, Ames, IA (1981)

Health Care Economics (1981) for Blue Cross/Blue Shield

Health Care Economics (1985) Revised (with W. Dunkelberg)

Health Care Economics (1987) Revised (with W. Dunkelberg)

Journal Articles

"The California Gold Rush: A Study of Emerging Property Rights," *Explorations in Economic History*, August 1977.

"A Theory of Contract Choice," *Journal of Law and Economics*. October 1977.

Reprinted in *Law and Economics*, Garland Publishing, Hamden, CT., forthcoming.

"The Welfare Effects of Sales Maximization: A Methodological Critique," *Economic Inquiry*, January 1979.

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Law Firm: Sommer & Barnard
Attorney: William C. Barnard
Indianapolis, IN

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Law Firm: Lange, Simpson, Robinson & Somerville
Attorney: Lawrence B. Clark
Birmingham, AL

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Law Firm: Huey, Guilday, Kuersteiner & Hecker, P.A.
Attorney: Geoffrey B. Schwartz
Tallahassee, FL

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Law Firm: Dykema, Gossett, Spencer, Goodnow, & Trigg
Attorney: Barbara L. Goldman
Detroit, MI

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Law Firm: Baker & Daniels
Attorney: Kevin Toner
Indianapolis, IN

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Law Firm Collier, Shannon, Rill & Scott
Attorney: John Williams
Washington, DC

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Law Firm: Tuttle & Taylor
Attorney: Diann Kim
Los Angeles, CA

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Law Finn: Tabbert, Cramer, & Capehart
Attorney: Charles F. Cromer, Jr.
Indianapolis, IN

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Law Firm: Robins, Zelle, Larson & Kaplan
Attorney: Lawrence T. Hofmann
Minneapolis, MN

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Law Firm: Barnes & Thornberg
Attorney: Don Knebel
Indianapolis, IN

Senesac Equipment v. J.I. Case Credit Corporation
Law Firm: Foley & Lardner
Attorney: Robert DuPuy
Milwaukee, WI

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Law Firm: Reed, Smith, Shaw & McClay
Attorney: Daniel I. Booker
Pittsburgh, PA

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Law Firm: Richard Neuman
Attorney: Richard E. Neuman
San Francisco, CA

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Law Firm: Howrey & Simon
Attorney: Dave Kaplan
Washington, DC

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Law Firm: Williams & Connolly
Attorney: Stephen L. Urbanczyk
Washington, DC

John L. Baltz, et al., v. Bulk Petroleum Corporation
Law Firm: Foley & Lardner
Attorney: Robert DuPuy
Milwaukee, WI

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Law Film: Texaco, Inc.
Attorney: Joseph P. Foley
White Plains, NY

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Law Firm: Kirkland & Ellis
Attorney: Jack A. Rovner
Chicago, IL

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Law Firm: Texaco Inc.
Attorney: Terri J. Frank
White Plains, NY

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Law Firm: Sommer & Barnard
Attorney: Gordon L. Pittenger
Indianapolis, IN

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Law Firm: Paxton & Seasongood
Attorney: Jacob Stein
Cincinnati, OH
Law Firm: Wildman, Harrold, Allen & Dixon
Attorney: Mike Grant Chicago, IL

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Law Firm: Barnes & Thornberg
Attorney: Don Kriebel
Indianapolis, IN

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Law Firm: Sommer & Barnard
Attorney: William Barnard
Indianapolis, IN

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Law Firm: Pillsbury, Madison & Sutro
Attorney: Roxane Polidora
San Francisco, CA

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Law firm: Brobeck, Phleger & Harrison
Attorney: Earle Miller
Los Angeles, CA.

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Law firm: Mallery & Zimmerman, S.C.
Attorney: Thomas F. Mallery
Wausau, WI

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Law film: Smaltz & Anderson
Attorney: Don Smaltz
Los Angeles, CA

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Law firm: Pillsbury Madison & Sutra
Attorney: Robert A. Mittelstaedt
San Francisco, CA

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Exxon Attorney: Greg Vint
Law firm: Goodwin & Goodwin
Attorney: Tom Goodwin
Charleston, WV

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Law firm: Sommer & Barnard
Attorney: Edward W. Harris III
Indianapolis, IN

Corp v. Kinnear
Law firm: Lee, Smart, Cook, Martin & Patterson, P.S., Inc.
Attorney Joel E. Wright
Seattle, WA

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Law firm: Pillsbury Madison & Sutro
Attorney: Robert A. Mittelstaedt
San Francisco, CA

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Law firm: Balch & Bingham
Attorney: Cavender C. Kimble
Birmingham, AL

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Law firm: Sidley & Austin
Attorney: John M. George, Jr.
Chicago, IL

Bohan v. Unocal
Law firm: Wilner, Klein & Siegel
Attorney: Samuel Wilner
Beverly Hills, CA.

El Paso Refinery, L.P.
Law firm: Pillsbury Madison & Sutro
Attorney: Philip S. Warden
San Francisco, CA.

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Law firm: Hogan and Hartson
Attorney: Edward C. Duekers
Washington D.C.

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Law firm: ARCO
Attorney: Ron Redcay
Los Angeles, CA

Norman Law, et al. V. NCAA
Law firm: Sommer & Barnard
Attorney: William C. Barnard
Indianapolis, IN
Law firm Mayer, Brown & Platt
Attorney: Alan N. Salpeter
Chicago, IL
Law firm: Miller, Canfield, Paddock and Stone
Attorney: Gregory L. Curtner
Ann Arbor, MI

Consulting

National Committee on Electronic Funds Transfer Systems

Great Lakes Chemical Corporation

Blue Cross/Blue Shield, National Association

Marathon Oil Company

Indiana Petroleum Council

Committee of Independent Refiner Marketers

Associated Petroleum Industries of Pennsylvania

Jones and Laughlin Steel Corporation

Atlantic Richfield Company

R.R. Donnelly and Sons Company

Conoco, Inc.

Public Service Indiana

Delaware Petroleum Council

General Electric Company

Texaco, Inc.

Amoco

Southland Corporation

Blue Cross Indiana

Ashland Oil Inc.

Indiana State Farm Co-op.

E. & J. Gallo Winery

Indiana Corn Growers Association

Archer Daniels Midland

South Point Ethanol

Anheuser-Busch, Inc.

British Petroleum

Chevron

Cohn and Son, Inc.

Florida Petroleum Council

Lazzara Oil Co. Inc.

First Financial Bank, FSB

Exxon

Standard Oil of Ohio

Time Oil Inc.

Mobil Oil Corp.

Standard Oil of California

American Petroleum Institute

Michigan Petroleum Council

Blue Cross and Blue Shield of Alabama

Unocal

Western States Petroleum Association

Cumberland Farms

Business Experience

Board of Directors – Nova Concepts, Inc. 1984-1992

Board of Directors – Phytodynamics, Inc. 1987-1988

Board of Directors – Qualitron, Inc. 1992-1998

KOSHIBA AGENA & KUBOTA

JAMES E. T. KOSHIBA 768-0
CHARLES A. PRICE 5098-0
2600 Pauahi Tower
1001 Bishop Street
Honolulu, Hawaii 96813
Telephone No: 523-3900

Attorneys for Defendants

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

CHEVRON U.S.A. INC., a Pennsylvania Corporation, Plaintiff, vs. BENJAMIN J. CAYETANO, Governor of the State of Hawaii; EARL I. ANZAI, Attorney General of the State of Hawaii, Defendants.	CIVIL NO. 97-00933 SOM (Constitutionality of State Statute) DIRECT TESTIMONY BY DECLARATION OF EXPERT WITNESS KEITH LEFFLER; EXHIBIT "1"; CERTIFICATE OF SERVICE Trial Date: February 26, 2002 Judge: Hon. Susan O. Mollway (Filed Feb. 25, 2002)

DIRECT TESTIMONY BY DECLARATION OF EXPERT WITNESS KEITH LEFFLER

Qualifications

1. I, Keith Leffler, am an Associate Professor of Economics at the University of Washington. I have a Ph.D. in economics from UCLA. I teach Microeconomics and

Antitrust Economics. I have taught antitrust economics and industrial organization at the Ph.D. level for over twenty years. A resume summarizing my academic experience, publications, and litigation and consulting experience is attached as Exhibit "1" and incorporated herein.

2. I have served as an economic consultant for state and federal governments and for numerous law firms and corporations. I have been qualified as an economic expert in industrial organization and antitrust economics in proceedings before state and federal courts and various federal agencies.

3. I have particular experience in the economic analysis and study of the petroleum industry. I spent parts of fifteen years working with the state attorneys general of Arizona, California, Washington, and Oregon, studying the petroleum industry in my consulting work on the Coordinated Petroleum Products Case known as MDL 150. I also evaluated the effects of the Exxon Valdez spill on gasoline prices for the states of Idaho, Oregon, and Washington. I assisted the states of Arizona and California in evaluating the competitiveness of gasoline prices throughout the state. I have also consulted in a number of gasoline dealer cases involving the competitive impact of pricing and rent policies.

4. I have assisted the Federal Trade Commission, the Department of Justice and the state attorneys general in the study of the likely impact on consumers from mergers in the petroleum industry. I was the economist for the Federal Trade Commission in their evaluation of the competitive impact of the merger of Standard and Gulf Oil. I was also the FTC's economist in a number of other petroleum mergers including PRI-Shell in Hawaii, Shell-Mobil in Guam, and Marathon-Ashland on the mainland. I

also assisted state attorneys general in petroleum related merger evaluations including Mobil-BP, BP-Tosco, ARCO-Thrifty, Tosco-Unocal, Shell-Texaco, BP-Arco and Chevron-Texaco.

5. My petroleum related work has included a number of studies of the market in Hawaii. In addition to merger evaluations related to PRI-Shell, Shell-Texaco and Chevron-Texaco, I also assisted the Hawaii State Attorney General in the evaluation of gasoline prices in Hawaii in the early and mid 1990's, performed an evaluation of the prices and performance of the Chevron Hawaii refinery as compared to its west coast refineries, and provided opinions in connection with the state attorney general's antitrust lawsuit involving gasoline pricing in Hawaii. In each of these projects, I had to become quite familiar with the supply sources, competitors, and the markets for petroleum products in Hawaii.

Materials Reviewed

6. I have worked with the Hawaii state attorney general's office in evaluating the likely impact of the rental aspects of Act 257 since November 1997. I have reviewed Act 257 and its precedent bills in both Houses. I have also reviewed Chevron's complaint, the Stipulation of Facts, Professor Umbeck's Declarations, the parties' filings in connection with their cross-motions for summary judgment and the courts' rulings relating to same. I have had access to the materials Chevron has provided the attorney general and I have studied and reviewed these materials. I have also relied on my background and experience in the economics of the petroleum industry and my professional training.

Summary of Opinions

7. A short summary of my opinions is as follows:

a. The lease rent cap imposed by Act 257 is likely to lessen the adverse competitive effects that result from the highly concentrated gasoline markets in Hawaii by maintaining the viability of independent dealers and thereby benefit consumers by reducing gasoline prices below what they would be otherwise.

b. An oil company is unlikely to raise its wholesale price of gasoline to offset lost rental revenue due to the imposition of Act 257, if any, because its wholesale price is already set at the profit-maximizing level.

c. Whether current dealers capture a "premium" when selling their dealer rights will not negate the beneficial impact of Act 257.

The Lease Rent Cap Will Lessen the Adverse Competitive Impacts from High Concentration

8. Act 257's "Legislative findings and declarations" or preamble provides in relevant part as follows:

> (4) Because Hawaii is a physically small and geographically remote economy, certain of its markets tend to be concentrated. Market concentration is a function of the number of firms in the market and their respective market shares. In a highly concentrated market, market prices tend to rise above competitive levels. Market prices persistently above competitive levels are harmful to the consumers and the public. Barriers to competition tend to cause supra competitive prices to persist; and

(5) The markets for oil and oil products in Hawaii are highly concentrated markets.

9. The highly concentrated gasoline industry in Hawaii is economically described as an oligopoly which is a market with few sellers. In 1997, Hawaii had two refineries that supplied gasoline to essentially six wholesalers.

10. In a competitive market, one with many sellers, each seller is not individually significant enough to have a measurable impact on the industry supply. The sellers therefore act independently of each other. In a highly concentrated market, however, each seller will recognize that its decision will have significant impact on the market and on the other competitors. Each seller will therefore take into account how its competitors will react to its decisions about marketing, supply and price. The sellers are described as being interdependent rather than independent competitors. There is an economic expectation of reduced competition because of the high concentration. A characteristic of oligopoly is that individual firms pursuing their own individual interests will not "rock the boat" and will try to avoid price wars and battles for market share. A concern is that high concentration may have the anticompetitive effect of tacit or effective cooperation rather than competition among the few firms resulting in high prices to consumers.

11. While the supply of gasoline at wholesale in Hawaii is highly concentrated, the retailing of gasoline is not. Hawaii has many retail gasoline stations, although the number is declining. Some of these stations are oil company owned and operated, a few are owned by the parties operating them, others are owned by oil companies but leased to dealers who have a franchise or lessee dealer

agreement with the oil company that owns the property. Act 257 concerns lessee dealer stations.

12. Because there are many decision makers involved in the retailing of gasoline in Hawaii, there is a strong economic expectation that the pricing at retail will be competitive. The street price of gasoline to the consumers in Hawaii is therefore expected to be the sum of the oligopolistic wholesale price plus a competitive retail margin. That average competitive retail margin will be determined by the number of competing retail stations in an area, the specific locations of the stations, and the quality of the stations including such factors as street presence and ease of ingress and egress.

13. Act 257's cap on the rent amounts charged lessee dealers, will lessen the anticompetitive impact of high concentration in the gasoline market in Hawaii in two ways. First, Lessee dealers are independent price setters that compete with one another and with company operated stations. The more competition and independent price setters at the retail level the better. By protecting lessee dealers and maintaining their presence in the market, the rent cap tends to prevent increased concentration at the retail level. Intraband and interbrand competition at the retail level are thus enhanced.

14. Second, Act 257, by maintaining the presence of independent lessee dealers in the retail market, also acts as a deterrent to cooperative pricing among the few suppliers of gasoline at the wholesale level. The likelihood of cooperation in oligopolistic pricing of gasoline is enhanced if the suppliers can more easily determine the prices of their competitors. The prices to the petroleum companies' dealers are not public prices. The petroleum

companies subscribe to information services such as Lundberg that collect and report the prices to the dealers; however, these sources of information about competitors' prices are both incomplete and delayed. This offers an individual wholesale supplier with an opportunity to shade price to some of its dealers and try to increase market share. These opportunities to profitably compete are more likely to occur if the competitors cannot immediately detect and react to such competitive pricing.

15. The presence of the independent dealers obscures to the other suppliers the wholesale prices actually being charged. Since an observed lower street price may be the result of a more competitive wholesale price or rather the result of a dealer aggressively competing at retail. The effective coordination of pricing by oligopolists requires an effective means for each of the few sellers to monitor the pricing activities of their competitors. When the street prices are, in part, a result of the independent business decisions of a host of lessee dealers, the ability to monitor the pricing actions of the few wholesale oligopoly suppliers is made more difficult. This increased price monitoring cost disrupts, to some degree, the oligopolistic price coordination at the wholesale level. By protecting the viability of the independent lessee dealers, the rent cap provisions of Act 257 make cooperation in the highly concentrated petroleum markers in Hawaii more difficult. If the lessee dealers were no longer an active competitive force in the Hawaii gasoline market, then I would expect that there would be an increase in the wholesale gasoline prices due to increased cooperation among the relatively few suppliers of gasoline. The higher wholesale prices would in turn lead to higher retail prices to consumers.

16. Act 257 raises the cost of any attempts by a petroleum company to drive its dealers from the market and is thereby lessens the adverse effects of the highly concentrated gasoline markers in Hawaii. A wholesaler of gasoline can impact the economic viability of its dealers through two variables, the rent and the wholesale gasoline (dealer tankwagon or DTW) price it charges. Raising the DTW price is, however, relatively costly to the wholesaler as compared to a rental increase as the former likely will lead directly to reductions in volume as dealers react by raising their street price. Act 257 limits the petroleum companies' ability to adjust optimally the mix of DTW and rent in an attempt to drive dealers from the market. Thus, by increasing the cost of driving lessee dealers from the market, Act 257 perpetuates the beneficial impact of independent lessee dealers in a market that is highly concentrated at the wholesale level.

17. It is unlikely that the oil company will increase its DTW price to offset any lost rental revenue that might occur as a consequence of Act 257. The best wholesale price depends upon demand, supply, and the interrelationships among the few suppliers. Neither supply, demand nor the interrelationships among the suppliers are expected to change because a oil company is unable to increase the rent to its dealers. Therefore, the best, profit-maximizing price to the dealers does not depend upon the rent levels. If the oil company could increase its price to dealers and thereby increase its profits from the sale of gasoline, it would do so, and it would do so regardless of Act 257.

18. If higher DTW prices increase the profits from gasoline sales through dealers, then higher prices are expected to be charged. This expectation has nothing to do

with the level of rental revenue. Oil companies could offset any lost rental revenue by increasing DTW prices only if they were not already charging the best, profit-maximizing prices. Economic analysis assumes companies set profit-maximizing prices. Therefore, the DTW price increase offset possibility is inconsistent with basic economic principles.

19. Act 257 will constrain the oil companies from rent increases that make dealer stations unprofitable, thereby increasing the viability of the of the lessee dealer network. Act 257 is not expected to have any significant adverse effect upon the oil companies decisions to invest in their dealer network for a number of reasons. First, the petroleum companies are generally not expanding their dealer networks anyway. Hence, the possibility that Act 257 will reduce their incentives to expand the dealer network is of little practical significance. Second, as regards to current dealers, the protections of the federal Petroleum Marketing Practices Act constrain any reduced incentives to maintain or support current dealers. In addition, the investment decisions will be guided by the additional profits from additional sales that result from the investments, and these additional profits result from gasoline sales not rents. Finally, the current and planned rents are generally below those allowed by Act 257. Therefore, Act 257 should mainly restrain substantial rental increases that might be designed to reduce or eliminate the dealer network, and this restraint simply has nothing to do with maintenance incentives.

20. Standard textbook economic analysis of rent control is irrelevant to the analysis of Act 257 because the standard analysis is in the context of competitive residential landlord/tenant markets. The standard analysis

presumes that the rent controls are designed to aid renters. The standard analysis, therefore, emphasizes the adverse effects on competitive landlords' incentives to maintain and expand the supply of rental housing. Act 257, however, is intended to constrain the above competitive prices in the highly concentrated, non-competitive gasoline supply market. The impact is generally not to benefit dealers immediately but to prevent future actions injuring the dealers. In fact, standard economic analysis does show that the traditional adverse effects of price controls that reduce supply, may not occur in non-competitive markets but, rather, that the price control can increase supply when competition is not present.

<u>The Beneficial Impacts on Gasoline Prices In Hawaii Result Regardless of Whether the Cost Reductions are Captured by Current Dealers</u>

21. The beneficial impacts from Act 257 occur regardless of whether current dealers could capture the entire value of any rent reductions in subsequent transfers. Whether a premium is captured is, therefore, irrelevant to the Act's intended impact of constraining the anti-competitive price effects in a highly concentrated market.

22. If a particular Chevron lessee dealer did successfully increase the sale price for transferring the rights to operate the station by the full present value of any unknown and uncertain rental reductions that might be caused by Act 257, the new dealer would not have any direct economic benefit from the Act. Nonetheless, the viability of the station after the transfer would be favorably impacted. The impact on the viability of the new dealer occurs because, independent of any changes in the up-front price that a new dealer pays to an incumbent dealer,

lower monthly rent payments reduce the new dealer's cost of *continued* operation. The purchase cost of the right to operate a station is economically known as a sunk or fixed cost. The new dealer is out the sunk cost the day he buys the station. This cost is sunk regardless of whether the station continues in operation or shuts down. It is a basic economic proposition that sunk costs do not affect marginal decisions. "Fixed costs, by definition, occur independently of how much the firm produces, or whether it produces at all. Since they are sunk, and the firm cannot recover them, they cannot affect behavior," G. Silberberg, *Principles of Microeconomics*, 1995, Prentice Hall, p. 261; "(An initial investment cost) is sunk and gone, and is irrelevant for any costs of operation once the investment is made. It doesn't appear in future production costs, and the investor hopes to recover it from future revenues, taking a loss if he does not." A. Alchian and W. Allen, *Exchange and Production: Competition, Coordination, & Control*, 1983, Wadsworth, p. 209. The relevant marginal decision, in this context, is whether or not to keep operating a lessee dealer station. The amount of the up-front purchase price does not affect this marginal decision. Rather the revenues from continued operation as compared to the costs of continued operation are what matter.

23. An example illustrates the effect of Act 257 in this regard. Assume the Act cuts a dealer's rent from $5,000 to $4,000 per month. As long as the dealer's net income (after paying all expenses but rent) from gasoline sales exceeds $4,000 per month, the dealer is better off continuing in operation rather than shutting down. Now assume the dealer sells his station right and, because of the reduced rent, receives an additional $100,000, assumed to be the full present value of lower rent, The new

dealer would, of course, only pay this additional amount because of the expectation of in fact receiving the extra $1,000 per month. If, however, adverse events occurred that lowered the net income, it would be in the economic best interests of the new dealer, just like the original dealer, to continue in business as long as the lower net income continued to exceed the reduced rent; that is, as long as the net income exceeded the reduced $4,000 rent. Thus, the beneficial effects of Act 257 on lessee dealers' continued business operation occurs independently of whether the incumbent dealers capture rent reductions in subsequent sale prices. Act 257 therefore lessens the impact of the high concentration in Hawaii's petroleum markets by increasing the viability of independent dealers regardless of whether incumbent dealers could capture any rent reductions when transferring their stations.

<u>The Benefits of Act 257 to Current Dealers Will Not Likely be Fully Captured If the Lease rights are Transferred</u>

24. As a practical matter, any reductions in rent caused by Act 257 will not be fully capitalized in subsequent transfer prices by the current lessee dealers. This is because there are many unknown variables, e.g., forecasting future rent and the future level of gasoline margins and the sales of goods other than gasoline. Also, economically, any cost reductions from Act 257 will be fully captured by sellers only if the market for the sale of lessee dealer rights is perfectly competitive, and, in Hawaii, the low number of sales of dealer rights per year show such a thin market that certainly does not approximate a perfectly competitive market.

I declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge.

Honolulu, Hawaii; February 25, 2002.

/s/ Keith Leffler
KEITH LEFFLER

EXHIBIT 1

Keith E. Leffler
Curriculum Vitae

January 1998

University Office: Department of Economics, DK-30
University of Washington
Seattle, WA 98195
Phone (206) 543-5795
Fax (206) 685-7477

Off Campus Office: 15314 Beach Drive NE
Seattle, WA 98155
Phone (206) 367-7335
Fax (206) 367-7482

Education: University of Alaska Anchorage
California State University Northridge
BA. 1972 Economics
University of California Los Angeles
MA 1974 Economics Ph.D. 1977
Economics

Specialties: Industrial Organization
Antitrust Economics
Economics of Contracts

Academic Appointment: Associate Professor of Economics
University of Washington

PAPERS, PUBLICATIONS, REPORTS AND PRESENTATIONS:

"Vertical Restraints After State Oil v. Khan," forthcoming, Washington State Bar Antitrust Newsletter, 1998

"Analysis of Gasoline Pricing in Arizona," report to the Arizona Attorney General's Office, 1998.

"The Competitive Impacts of ATM Surcharges," presented to the Washington State House and Senate Committees on Financial Institutions, 1997.

"Exclusive Dealing as a Facilitating Practice in Coordinated Oligopolistic Pricing," presented to the National Association of State Attorney Generals and the Antitrust Section of the Washington State Bar Association, 1996.

"The Economics of Presale Measurement: An Analysis of Presale Measurement in Competitive Timber Auctions," (with R. Rucker and I. Munn), presented to the Western Economic Association, University of Washington Working Paper, 1996.

"Competition in Gasoline-Markets," presented to the Washington State Senate Law and Justice Committee, 1994.

"The Use of Economics in Antitrust Proceedings", 1993, presented to the Antitrust Division of the Washington State Bar.

Information and Pharmaceutical Advertising", 1993, presented at the University of California Los Angeles.

"The Price Effects of Entry When Information Is Costly," 1992, presented at the University of Arizona.

"Private actions and Proof of Damages in Secondary Line Cases – The Texaco v. Hasbrouck Case," (with R. Whaley), Antitrust Law Journal volume 59, 1991.

"Transactions Costs and Economic Organization: A Study of Timber Harvesting Contracts," (with R. Rucker), Journal of Political Economy, October 1991, presented at Clemson University, the University of Chicago and Simon Fraser University.

"Prescription Drug Prices and Generic Entry: Bias in Measured Inflation," 1991, presented to the Conference on Pharmaceutical Economics, 1991.

"Regulating Gasoline Margins by Sector," testimony before the Washington State Senate Law and Justice Committee, 1991.

"Did the Federal Trade Commission's Advertising Substantiation Program Promote More Credible Advertising?" (with R Sauer), American Economic Review, March 1990.

"The Impact of the Iraqi invasion on Gasoline Prices," presented on The Compton Report, 1990.

"Franchising Contracts and the Protection of Information," 1989, presented to the Marketing Department, University of Washington.

"Multigood Pricing and Tie-In Sales," 1989, presented at North Carolina State University.

"The impact of the Exxon Valdez Spill on Gasoline Prices," 1989, Report for the Attorney Generals of Washington, Oregon and Idaho.

"Revenue from Public Natural Resource Sales: A Study of Timber Harvest Incentives," (with Rucker), Review of Economics and Statistics, May 1988.

"Duality Assurance in Retail Markets through Resale Price Maintenance," 1988, presented at the Department of Justice.

"Resale Price Maintenance and Retail Shelf Space Competition," 1987, presented at Washington University, St Louis.

"An Analysis of the Theory of Entry Deterrence;" 1987, presented to the Antitrust Section of the Washington State Bar.

"An Analysis of Gasoline Prices at Company Owned and Independently Owned Branded Stations," 1987, Report for the Washington State Legislature.

"Geographic Market Share: An Economist's Perspective of A Legal Quagmire," 1986, presented at the American Bar Association Meetings, San Francisco.

"Towards a Reasonable Rule of Reason," Journal of Law and Economics, May 1985, presented at the Hoover Institute, Stanford University.

"The Effects of the Advertising Substantiation Program on Advertising Agencies," (with R Sauer), in Regulation and Consumer Protection, presented to the Federal Trade Commission 1985.

"Analysis of the Alaska Pulp Company Antitrust Case," 1985, presented to the National Association of Attorney Generals.

"Arizona v. Maricopa County Medical Society: Maximum Price Agreements in Markets with Insured Buyers," Supreme Court Economic Review, 1983.

"Economic and Legal Analysis of Medical Ethics: The Case of Restrictions on Interprofessional Association," Law and Human Behavior, September 1983.

"Ambiguous Changes in Product Quality," American Economic Review, December 1982, presented at the American Economic Association, the University of Chicago, and Ohio State University.

"The Prohibition of Billboard Advertising: An Economic Analysis of Metromedia," Supreme Court Economic Review, 1982.

"Review of Regulating the Professions," editors Blair and Rubin, Journal of Political Economy, January 1982.

"The Role of Market Forces in Assuring Contractual Performance," (with B. Klein); Journal of Political Economy, January 1982, presented at the University of Rochester, the University of Chicago and the University of California at Los Angeles.

"Student Discount Rates, Consumption Loans and Subsidies to Professional Training, (with C. Lindsay), Journal of Human Resources, Summer 1981.

"Persuasion or Information? The Economics of Prescription Drug Advertising," The Journal of Law and Economics, April 1981, presented to the Western Economics Association.

"A Simple Model of Competitive Industry Equilibrium in New Product Research and Development," Economic Inquiry, January 1981.

"The ignored Issue in Economic Analysis of Minimum Wages," in The Economics of Legal Minimum Wages, 1981, presented to the American Enterprise Institute.

"Markets for Medical Care and Medical Education: An Integrated Long Run Structural Approach," (with C. Lindsay), Journal of Human Resources, Winter 1981, presented to the Southern Economics Association.

"Why Does Advertising Increase Demand?" presented to the American Advertising Association, 1980.

"The Economics of Product-Positioning", Journal of Business, August 1980, presented to Conference of Economics in Marketing, University of Rochester.

"Markets, Quality Uncertainty, and Professional Licensure," in Occupational Licensure and Regulation, 1980, presented to the American Enterprise Institute.

"The Competitive Effects of Advertising," Advertising Age, November 1980.

"Signaling: Efficiency and Equilibrium," (with J. Long and T. Russell), Economic Letters, Summer 1979.

"How Do Human Capital Investors Form Earnings Expectations?" (with C. Lindsay), Southern Economic Journal, October 1979.

"Do Physicians Create Demand?", Patient Care, May 1979.

Doctors' Fees and Health Care Costs," guest editorial, The Wall Street Journal, February 2, 1979.

Minimum Wages, Welfare and Wealth Transfers to the Poor," Journal of Law and Economics, October 1978.

"Government Output and International Income Comparisons," Journal of Monetary Economics, July 1978, presented at Carnegie Mellon University.

"Physician Licensure: Competition and Monopoly in American Medicine," Journal of Law and Economics, April 1978, presented at University of Rochester, the National Bureau of Economic Research, Purdue University, and the University of Chicago.

"Explanations in Search of Facts: A Critique of the Council of Wage and Price Stability Report on Physician Fees," Occasional Papers, Center for Law and Economics, University of Miami, 1979.

"The Market for Medical Care," (with C. Lindsay) in New Directions in Public Health Care, 1976.

WORK IN PROGRESS:

"Illinois Brick and Antitrust Damages"

"Transactions Costs and the Efficient Contract Structures in Oil Leasing."

PAST EDITORIAL POSITIONS:

Associate Editor, Review of Industrial Organization.

Associate Editor, Managerial Decision Economics.

GRANTS:

Earhardt Foundation, dissertation grant.

Robert Wood Johnson Foundation, grant to study competition in physician services markets.

Pfizer, Inc., fellowship to study competitive issues in the pharmaceutical industry.

Center for Research in Political Economy, grant to study public timber contracts.

Law and Economics Center, University of Miami, grant to study the pricing of physician services.

Pacific Institute, grant to study the effects of licensure on product quality.

American Enterprise Institute, grant to study the economics of advertising.

The Federal Trade Commission, grant to study the effect of advertising regulation.

US Department of Agriculture, grants to study timber contracts and oil leasing.

TEACHING:

Antitrust Economics, senior and graduate levels.

Microeconomic theory, beginning and graduate levels.

Industrial Organization, senior and graduate levels.

Continuing Legal Education Classes in Antitrust Economics, presented to the Washington State Attorney General's Office.

Antitrust economics lectures at the University of Washington Law School and Seattle University Law School.

MAJOR CONSULTING WORK:

MDL150 Coordinated Petroleum Products Litigation

Wilk, et.al. v. AMA, et.al.

FTC Investigation of the SOCAL – Gulf Oil merger

Hasbrouck v. Texaco

Coordinated Corrugated Container Antitrust Litigation

DES Market Share Reconstructions

U.S. v. Brown et.al.

FTC and DOJ Investigations of Microsoft

Infant Formula Antitrust Litigation

Rebel Oil v. ARCO

DOJ Investigation of the American Bar Association Law School Accreditation Policies

Brand Name Prescription Drug Antitrust Litigation

FTC v. Butterworth – Blodgett Hospitals

Washington, Oregon, California and Arizona investigation of Tosco-Unocal merger.

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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

CHEVRON U.S.A., INC. Plaintiff, vs. BENJAMIN CAYETANO, et al., Defendants.	CV 97-00933 SOM Honolulu, Hawaii February 26, 2002 9:00 A.M. Non-Jury Trial

TRANSCRIPT OF NON-JURY TRIAL PROCEEDINGS
BEFORE THE HONORABLE SUSAN OKI MOLLWAY
UNITED STATES DISTRICT JUDGE

* * *

[9]Q I'd like to start by asking you some questions about your working relationship with Chevron and other oil companies in the past. You have testified in numerous depositions and in trials on behalf of Chevron and other oil companies; is that correct?

A Yes.

Q You've testified on behalf of Equilon before?

A In trial?

Q In a deposition or trial.

A Yes.

Q Equilon is a joint venture between Texaco and Shell and Star that was formed in 1998; is that correct?

A That's my understanding, yes.

Q And you testified on behalf of Equilon in a Los [10] Angeles case called Coast Village?

A Yes.

Q And that case involved a group of Shell lessee-dealers?

A Yes.

Q And the Shell lessee-dealers claim that Shell Equilon was trying to drive them out of business by raising their rent, among other things; correct?

A That was one of the claims, yes, uh-huh.

Q You were also retained on behalf of Equilon in a Houston lawsuit?

A Yes.

Q That suit was also against lessee-dealers?

A Against? I mean they were the ones who brought the claims.

Q Against Equilon; is that correct?

A They brought claims against Equilon. Let me think here. Try and remember if they named Shell and Equilon or Shell only. But one or more of the components of Equilon were involved there, yes.

Q In that Houston lawsuit generally the lessee-dealers were claiming that Shell or Equilon were treating them unfairly in some way; correct?

A Yes.

Q You've also testified on behalf of Shell in an [11] Indianapolis lawsuit; is that right?

A I don't believe my deposition was taken before it was settled. I had been retained by them to counsel them on the economic aspects of the argument.

Q And that was called the Becker Oil versus Shell case?

A Something like that, uh-huh.

Q And lessee-dealers had sued Shell in that case as well?

A Yes, uh-huh.

Q The lessee-dealers in that case against Shell claimed that Shell was trying to drive them out of business so that Shell could convert to company-operated stations. Wasn't that one of the allegations?

A That – to the best of my memory, yes, that was one of the allegations.

Q You were retained on behalf of a D.C. law firm in a case involving Cumberland Farms; is that right?

A That was 15 years ago. It could have been a Washington, D.C., law firm. I did some work for a firm related to some issues raised by Cumberland Farms, yes.

* * *

[14] Q I don't think that it does either. In that case, though, it was a case brought by lessee-dealers against Cumberland Farms.

A Probably. I think so, uh-huh.

Q And the lessee-dealers claim that Cumberland Farms unfairly raised the rent, didn't they.

A Sounds right, uh-huh.

* * *

[31] Q And your understanding is that Chevron today would prefer to build company-operated stations if it's a new ground-up $2 million facility; correct?

A It's my understanding that where – in those areas where Chevron would like to build that their preference would probably be more toward the company op, yes.

Q And company op as opposed to building and then leasing the station to a lessee-dealer.

A Yes.

Q And under those circumstances where Chevron has a company-owned station today Chevron controls the gasoline all the way from the refinery to the street.

A Is that a question?

Q Yes, sir.

A Yes.

* * *

[62] Q Dr. Leffler's final reason in paragraph 19 is that current and planned rents are generally below those allowed by Act 257, and, therefore, to paraphrase, it should mainly restrain substantial rent increases that might be designed to reduce or eliminate the dealer network, and this restraint simply has nothing to do with maintenance incentives.

First of all, do you have an understanding of what that means?

A Well, let me read it again.

Let's take the first statement. "Finally, the current and planned rents are generally below those allowed by Act 257." Well, the key word to look at there is the word "generally." In what I've seen of the financial documents in this case, on average Chevron's rents are relatively low and may in fact be below, on average, those [63] allowed by the law, but that's irrelevant to an economist. The question is at the margin are there any stations that are impacted, and the answer is again I've been told, and I've seen in the documents, that there are some Chevron stations that are currently charging a rent that is above what would be legally allowed. And it's the impact on those stations that we focus on in economics. So that's with respect to that first sentence.

"Therefore, Act 257 should mainly restrain substantial rent." Again "mainly," okay. You still have those stations that are at the margin impacted directly by the rent control. And for those stations it has nothing to do with whether you're going to have future increases in rent designed to reduce or eliminate the dealer network. That's just totally irrelevant. The question is those stations that are now impacted, there will be a disincentive to maintain those stations or to open new stations like them should the market move and relocate with population centers.

Q Okay. Before turning to paragraph 20 let me ask you a couple specific questions that were raised in your cross-examination. First of all, I think you said that Chevron typically owns the land under the lessee-dealer station.

A That was – I asked for qualification on that question [64] for that reason. Nationwide, if you look at Chevron's lessee-dealer network, for the most part the majority of them would be properties owned by Chevron. That's not true – that same observation does not apply in Hawai'i.

Q And what's the situation in Hawaii with respect to the land under the station?

A Now a much larger percent of the land underlying the lessee-dealer station is owned by somebody other than Chevron, and Chevron leases that land from a third party, puts the station on the land, and then leases it to a dealer.

Q Now, do you have an understanding – strike that.

As a matter of economics, when Chevron goes to renew or negotiate a renewal of that underlying ground lease for the station, do you have a view as to whether the rent control is going to affect Chevron's incentives in renegotiating or renewing the ground lease?

A Sure. If the rent control – if the rent control is truly effective, it will reduce the flow of money that Chevron gets from those stations. And by reducing the flow of revenue it reduces the profitability, it reduces the incentive to maintain that station, or in this case to renew the lease.

* * *

[92] Q And let's just go down to the State of Hawai'i, and for Chevron it shows what, about six company op?

A Yes. I think six.

Q It's a little illegible. Let's say six company op, 61 lessee-dealers.

[93] A Correct.

Q And six open dealers.

A Yes.

Q There's also some dealers that, instead of being supplied directly by one of the wholesalers, is supplied by a jobber, who is in between the wholesaler and the retailer.

A Yes. Typically on the outer islands; that's correct.

* * *

[96] Q And then you would take the company ops and Chevron has six out of a total of 300 stations.

A 2 percent.

Q So you'd say Chevron would have 2 percent, and you square that and that gives you 4 percent. And without going through the math for all the rest, by the time you add up all of these you end up with an HHI at the retail level of something very low.

A Probably 150.

Q And that falls into the highly competitive.

A Yes. It falls into the very unconcentrated level.

Q Okay. So at the retail level it's highly competitive or unconcentrated.

A Yes.

Q So it's your understanding that the legislature was concerned about high concentration at the wholesale level not about concentration at the retail level.

A Yes.

Q Because there's nothing to be concerned about from the concentration standpoint at the retail level.

A Certainly not at the current time.

* * *

[100] Q So, for example, if Chevron raises its DTW wholesale price to a dealer – to all of its dealers, let's say, on O'ahu, you would expect to see on average the dealers on O'ahu raising their retail price in reaction to the increase in the DTW.

A Yes.

* * *

[104] Q If somebody said to you Chevron is trying to drive its lessee-dealers out of business in Hawai'i by charging an excessive rent, you would say, "Not so. In fact, just the opposite."

A Well, I would say we'd have to examine it. That we [105] don't know. We have to look at the total payments in order to examine an issue like that.

It's as if I was renting you an apartment and I required you to get your cleaning services from me, and I was renting you a nice apartment here in Hawai'i for a hundred dollars a month but I was charging you a thousand dollars a week to have me clean the apartment. The hundred dollars wouldn't tell me anything yet without the understanding of the total payments required.

Q And for that reason, as you've said before, it's economically meaningless to look at rent without also considering gasoline revenues or vice versa.

A Certainly for the question you posed to me, yes.

* * *

[111] Q And that's because you think company-operated stations are more efficient than dealer stations.

A In today's gasoline retailing environment, yes, I think that's correct.

Q And over the years has it also been your observation that on average in general company-operated stations charge a lower retail price than lessee-dealer stations?

A Yes. Overall on average that's been my observation.

Q So, if you just take one market and all you want to do is have a lower average price, you would say the higher percentage of company-operated stations the lower the average retail price is going to be, just as a matter of arithmetic.

A Holding constant the DTW or holding constant the wholesale price, yes, company-operated stations tend to be able to operate under lower retail margins.

* * *

[114] Q I've gone back through those declarations and made a summary of the reasons that you gave in those declarations for high price levels at the wholesale level, the DTWs, and I'd just like to go down those – that list and, if you want to take a look at your prior declarations, if this doesn't ring a bell, I have copies here for you.

A Okay.

Q First of all, and this is a list of the reasons for the relatively high prices at the wholesale level.

A Okay.

Q Or at the retail level. Because in your view, as you've testified before, wholesale and retail prices go hand in hand.

A Yes.

Q Number 1, high taxes.

A Yes.

Q And those are taxes imposed by the federal government, the state government, and local governments.

A Well, the federal is universal throughout all the states; so all my comparisons would be area to area. So, [115] when I say high prices in Hawai'i, I mean high compared to other areas. So that would be – there are relatively high state taxes in Hawai'i on gasoline.

Q Number 2, high concentration at the wholesale level.

A Yes.

Q Meaning that there are six gasoline suppliers with market shares which, as we have seen, result in Herfindahl indices of 1800 or above.

A Yes.

Q Number 3, high entry barriers, meaning that without getting too precise about the definition there are impediments to new companies coming into the market.

A Yes.

Q And one way you have concluded that there are high entry barriers is otherwise additional companies would have entered the market given the profit opportunity reflected by the gasoline prices.

A Correct. The high prices couldn't be sustained if entry was easy.

Q And to list some or perhaps all of the entry barriers, one would be the substantial sunk costs and regulatory impediments for building new terminals.

A Yes.

Q Substantial sunk costs for providing retail outlets, the stations.

[116] A Yes.

Q And the market is already overbuilt with stations or oversupplied with stations.

A Yes.

Q And all of those factors make it more costly for a new company thinking about entering the market to actually do so.

A Correct.

Q You have advised Deputy Attorney General Ted Clause, who was the deputy in charge of investigating gasoline prices for the decade of the '90s, or for most of it at least, that there is one explanation for the high gasoline prices and margins, and that is that there are very few competitors and entry is relatively difficult. Correct?

A Yes.

Q It's also your view – and you've expressed this in sworn testimony – that the nature of the demand for various refined products here in Hawai'i contribute to the high prices in this sense: That the refineries must make a product slate tailored to the local market demand and there's a disproportionate amount of the low valued heavy fuel oil used by the utilities mainly, and that results in a higher cost for the more valued light products like gasoline.

A I'm afraid I have to phrase that one slightly [117] different. That is, in assessing whether or not the profits at the refining level are excessive, that needs to be taken account of. It doesn't really explain why – it has no independent value in explaining why the prices of particular products might be high.

Q Let me read this statement and see if you still agree with what you wrote back in 1997. "The relative isolation of Hawai'i requires these refineries to produce a product slate that is tailored to local demand." So far so good?

A Yes.

Q "This results in a disproportionate production of low valued heavy oils and a resulting high cost of the more valued light products, gasoline, diesel, and jet fuel."

A Yes, I agree with that.

Q It's also your view that in comparing markets the most significant factor in explaining low prices one plays relative to another is the presence of a reasonably-sized independent.

A There's certainly context in which that would be true. I don't know if I would agree with that as a general blanket statement in all context, but –

Q But where that's true it's true in part because independents tend to operate more through company-operated stations?

A No. It's because independents are – on average seem [118] to be less cooperative in small number situations.

Q They also offer a lesser package; right? They don't have typically credit cards, they don't typically have the location – the favorable locations for service stations that the major oil companies do?

A Yes. They tend to be price competitors. They focus on price.

Q And they tend to be lower priced.

A Yes.

Q So just from a matter of arithmetic the more and larger independents you have in a market the average price is going to be lower.

A Yes. Other things constant, yes.

Q And now I'm going beyond the reasons you've given before.

A Okay.

Q Would you agree that, if a location tends to have an antibusiness political climate, that tends to discourage new entrants. And let me give you an example because that's a pretty broad statement.

If a particular location controls the rents that an oil company can charge lessee-dealers, would you expect that that would be at least one factor a company would take into account in deciding whether to enter that market?

A Yes.

[119] Q You're aware that during the 1990s at various times the state legislature here considered bills to nationalize petroleum terminals.

A I'm only – the "nationalize" got me on that question.

Q To make them public.

A Okay.

Q To take them over from the oil companies.

A Yes.

Q And would you consider that as a factor that a new entrant would take into account in a negative way?

A Probably not in the context of Hawai'i because a new entrant has a real problem with terminal access; so from the view of an outsider they would view that as something that would allow them to enter more cheaply. In a more general broader context, I think a state taking action to, in effect, seize assets from a private company is not supportive of future entry.

Q And that's because, if you're a company thinking about entering the market and you know you're going to have to spend a lot of money, a sunk cost, if you will, to build a terminal with the prospect that that will be taken away from you, that would be a negative factor.

A Yes.

Q How about restrictions on building company-operated [120] stations close to the dealer locations that have already been taken?

A That is a factor that will generally raise the cost of entering or discourage entry.

Q And how about restrictions, just generally, on building the most efficient type of stations?

A Yes. Again, that would not be conducive to people viewing with favor entering into your market.

Q Now, none of those factors, except for the last ones about rent and so forth – let me strike that.

The factors you listed – taxes, high concentration at the wholesale level, high entry barriers, the refinery slate – none of those factors that contribute to higher prices depend on a claim that rent paid by lessee-dealers is too high; correct?

A Correct. Yes, I agree.

* * *

[121] Q So in the list of items that you have testified contribute to higher gasoline prices in Hawai'i would you agree that the rents being charged by Chevron to its lessee-dealers is not the problem? Is not the cause of high gasoline prices?

A Yes.

Q You'll agree with that.

A Yes.

* * *

[123] Q And with respect to lessee-dealers the decision on whether to build a new lessee-dealer station is a decision that's made by Chevron rather than a decision made by the dealer.

A Correct.

Q And so, if you're going to analyze whether new dealer stations are going to be built in the future, you look at the economics for Chevron.

A Correct.

* * *

[125] Q Your main contact with the state was Deputy Attorney General Ted Clause?

A Yes.

Q And you had a number of conversations and documents, memos, back and forth about whether or not that Act 257, in particular the rent control part, was going to be effective or whether it was going to be counterproductive with respect to gasoline prices; correct?

A Yes. We certainly had many extended discussions and exchanges concerning the possible impacts of the bill.

Q And at some point did Mr. Clause tell you whether or not he had advised that the governor veto the act because it would be ineffective or for some other reason?

A I don't know that I recall anything as strong as "advised to veto." I think that neither Mr. Clause nor I [126] thought it was a good bill in some large sense, but our focus was rather on what its impact might be in some particular dimensions.

Q Well, when you first looked at the rent control part of the bill, you thought that it would be ineffective because an oil company could simply raise the DTW price to make up for or to attempt to make up for the decrease in rent, based on your view that it's economically meaningless to look at rent without looking at gasoline and vice versa; correct?

A I don't recall that, but I may have. I certainly would be very cognizant of the fact that the analysis has to closely consider the various variables the oil company has to impact the dealers.

Q And your view was that, if the DTW or wholesale price increased to offset the rent reduction, then the bill would be doomed to be ineffective.

A If that was the effect, yes, I would agree.

Q And so you set about – strike that.

One of your early ideas was that somehow you needed to show that the rent control would combat the problems with the high concentration that the legislature was talking about.

A Yes. I certainly understood that in order for the control that was the subject of the bill to have any impact [127] on what the legislative preamble was saying was the problem that there had to be some nexus between the two.

Q But you also knew, as we've discussed, that changing the percentage of lessee-dealers and company-operated stations at the retail level was not going to effect wholesale gasoline prices.

A There's no direct impact. That's not to say that there can't be an indirect impact. And indeed I think the testimony describes what I concluded could be an indirect impact.

Q What I'm doing is going back to the start when you first started looking at this. And do you remember your declaration said maintaining the presence of lessee-dealers can serve the state's interest in limiting the extent of increased concentration and the impact of any increased concentration.

A In the original declaration?

Q Yes.

A I remember words to that effect, yes.

Q But then you realized that that argument concerned competition at the retail level, but that wasn't what the legislature was talking about.

A I'm having trouble only with – it sounds like I'm trying to recollect the thought processes as I was developing arguments, and I certainly don't have those [128] fresh in my mind.

MR. MITTELSTAEDT: Your Honor, I have the memorandum that I'd like to use just for purposes of refreshing the witness' declaration or –

THE COURT: Can you make sure you show that to counsel.

MR. MITTELSTAEDT: – recollection, I should say. May I approach?

THE COURT: Yes.

BY MR. MITTELSTAEDT:

Q We'll walk through that part of this. Do you recognize this is the form of a memo you sent to Mr. Clause –

A Yes.

Q – in March of 1998?

A Yes.

Q And you'll see in the first paragraph you say, "I've taken sections from the draft declaration and added some explanation."

A Yes.

Q And then in the first full paragraph you quote your draft declaration to the effect that I had just read the first part of.

A Yes.

Q Namely, that the presence of lessee-dealers limits the [129] extent of increased concentration and so forth.

A At the retail level, yes.

Q And then you say in the next paragraph, "This argument concerns competition at the retail level. We don't have any support available currently. Given the relatively small number of company-operated stations in Hawai'i, I don't think this is a very strong argument." You see that?

A Yes.

Q And that was your view at the time.

A Yes.

Q And then you say to get some support you need to look at a situation in which the number of stations was small such that adding to the company-operated numbers and lessening the number of independent dealers would cause a significant change in market structure. Do you see that?

A Yes, I do.

Q And you never analyzed that further or made an examination of such a situation, did you?

A No, I did not pursue effects at the retail level in and of themselves.

Q In the next paragraph you go on to what I call your monitoring argument.

A Okay.

Q Correct?

A Yes.

[130] Q And can we just take a second and work through this argument so it's clear. And I think there are a couple of steps to your argument. The first step is your view is that monitoring – and by monitoring (writing) you're talking about monitoring or detecting DTW price moves by looking at retail prices.

A Yes. Detecting changes in the wholesale price, and in this particular instance that would be the DTW.

Q So detecting changes in DTW from looking at retail prices.

A Yes.

Q And your view is that that is, if I can use a general noneconomic term, a bad thing because it facilitates cooperative or collusive pricing in an industry where there are few sellers.

A I'm a little hesitant to say bad, but, yes, I think the economic theory is pretty clear that transparency in pricing assists in cooperation and pricing. I wouldn't go as far as to use the word "collusion."

Q Instead of "bad" can I write "undesirable"?

A I try to stay away from a motive word such as that. Will lead to an increase in price or an expectation of a higher price.

Q Okay. And then the second part of your view is that you would like to do something or you think the legislature [131] should do something that makes it harder to detect DTW price changes.

A No. I mean I have never viewed my role in this at all as advising what the legislature should do.

Q Let me rephrase.

A Okay.

Q Your view is that, if you could show that the rent control made it more difficult to monitor or detect, that would be advancing a legitimate state interest.

A Yes.

A Given the preamble of the bill, it would be consistent with the nominal purpose of the bill to show that or to find that.

Q So you were looking for a way to show that the rent control bill would result in making it harder to monitor.

A I'm not sure "looking for" is the right word, but –

Q You were seeing if there was a way.

A I was looking for a connection between the rent control aspects of the bill and wholesale – high wholesale prices.

Q And, if you could find that rent control would make it harder to monitor, you would think of that as helpful to the state's case.

A Yes.

Q Your view is that the rent control will result in a [132] higher percentage of lessee-dealers, a greater number of lessee-dealers.

A No. No. My view is that the rent control will prevent or make more costly actions by the oil companies that would alter that mix. That is, the world is the way it is now, and I'm looking prospectively what might happen in the future.

Q Well, and your view is sometime in the future, if an oil company changes its present plan and decides to try and drive a dealer out of business by raising rents, then the rent control will prevent that.

A It will raise the cost of doing that. It will prevent it doing it via rent, yes, and thereby raise the cost of doing it.

Q And your view is at that time by raising the costs, making it more difficult to get rid of lessee-dealers, there

will be more lessee-dealers in the market than there otherwise would be.

A Yes.

Q So you're saying rent control – eventually, if an oil company does this, that, and the other thing, rent control (writing) leads to more lessee-dealers; right?

A First of all, I'd say rent "cap" not "control" because I'm concerned the situation where there's –

* * *

[133] THE WITNESS: And, secondly, that, as long as we're careful on our phrasing, you would be correct. It's not going to lead to more lessee-dealers. It's going to lead to more than otherwise would occur in a particular situation.

BY MR. MITTELSTAEDT:

Q Well, rent cap will lead to more lessee-dealers than without rent cap.

A In the situation where otherwise they would be reduced.

Q If oil companies come up with the plan to get rid of lessee-dealers by raising rent.

A Yes.

Q Now, so bottom line with all those conditions your theory is that what's good about rent control or the rent cap is that eventually in the future, if one thing or another happens, the rent control, the rent cap, will result in more lessee-dealers than otherwise would be the [134] case. And you say that's good because it will make monitoring more

difficult; companies will be unable to detect changes in DTW as well. Right?

A Well, again you're using the word "good" as if I'm doing some ethical evaluation of this process, rather –

Q Helpful to the state's case.

A Well, rather that there is a sound, reasonable economic theory in which the avowed purpose of the bill can be accomplished through the rent cap. And it is – the logic of it is I'm not sure exactly as you've outlined it but generally consistent with the outline you've offered.

* * *

[142] Q Was it also your view that, if the dealer tank wagon price was increased as a result of the rent control, then the retail price was also likely to increase? For the dealers?

A Yes. I'm sorry. I was just thinking of what you said. Yes.

Q And so it was your view that, if Chevron increased it its DTW because of the rent control, it would be awful hard to show any direct benefit to consumers because they would be paying a higher retail price.

A Well, it's an offset, certainly. I mean we'd have one factor leading to constraining prices that is more difficulty in cooperating at the wholesale level. Then we'd have another factor that's directly causing a price change in the upward direction. And it's kind of a balancing at that point.

Q You don't know where that comes out.

A No.

Q But, focusing on the retail price, when the DTW price increases, your view is the retail price increases; right?

A Yes.

* * *

[144] Q And your testimony in open court at least twice was that Chevron, presumably other oil companies, include rent in gasoline. And they can call it rent, they can call it gasoline, they can call it whatever they want, but between the rent and the gasoline they need to earn sufficient revenues to pay their costs plus a reasonable profit.

[145] A Yes. That they're charging the dealer for the right to occupy that station in two ways, just like my analogy of paying the rent for the apartment and then having to buy the cleaning. That that's part of the price you pay for occupying the station in this case.

* * *

[155] Q Okay. And in your declaration originally in this case you said that on average the dealers would capture that premium. Some would capture less, some would capture more, but on average they would capture the premium.

A I think, if it's not explicit, it's implicit.

Q Well, let me read from paragraph 16 of your declaration. "At best, we might expect the guesses of [156] potential buyers to be correct on average."

A Yes.

Q And then you say, "This implies half the purchasers would pay a premium less than the actual present value." And it was also true, isn't it, that the other half would pay more and so on average they would pay the premium.

A I think that's a fair expectation.

Q Now, in your written testimony, your direct testimony, you leave out the point about on average the dealers would pay the value of the premium. Or at least I didn't see it in there. Did you intend to exclude that on purpose?

A Not really. I thought that the important point here was that the Richardson analysis is irrelevant. And, therefore, the focus that I have in paragraphs 21 through 23 is to, I hope, carefully explain why it doesn't matter whether or not the incumbent dealers capture the premium for the analysis of whether or not the rent cap might affect high prices from high concentration.

Q And, if I can summarize your theory on that, your theory is that because paying the premium – when a new dealer pays the premium, that payment becomes a fixed cost rather than a variable cost.

A It's probably better to think of it as a sunk cost.

Q Sunk cost –

A Sunk. Gone.

[157] Q But it's also referred to as a sunk cost. That's a term you use?

A Sunk cost, yes.

Q So it converts it from a variable cost to a fixed cost or a sunk cost.

A Yes.

Q And your view is that at some time in the future, if the dealer falls on economic hard times, he will continue in business a little bit longer because he's only now looking at variable costs, and he's already paid the money for the premium in the past.

A Perhaps forever. I mean he will continue as long as the cash flow he's receiving from continued operation of the business exceeds the expenses he incurs because of continued operation of the business. And the premium is not a cost of continued operation of the business.

Q But you've also agreed that the relevant decision on whether a station is going to be built or whether the oil company is going to continue to use the station as a lessee-dealer station depends on the economics for the oil company.

A Yes.

Q And you agree that to the extent the dealers benefit from a rent cap with the premium or otherwise, that money goes into their pockets and comes out of Chevron's pocket.

[158] A Yes.

Q And reduces Chevron's incentive to build new lessee-dealer stations.

A Well, yes, the directional effect is clear. Yes, it reduces it.

* * *

[169] Q I see. Okay. And that establishes that in fact in Hawai'i at the relevant time the wholesale market was highly concentrated; correct?

[170] A Yes. It's just a quantification of a qualitative concentration notion.

Q Right. And, based upon the formula that is employed, the conclusion is that it's a highly concentrated market.

A Yes.

Q Down at the retail level, though, if you used the same HHI formula, what would the conclusion be? Would that be a highly concentrated market or not?

A No. As Mr. Mittelstaedt correctly noted there, it's highly competitive or unconcentrated.

Q Because there are many retailers at the retail level; is that correct?

A There are many independent individuals making decisions about retail price.

Q Okay. And that's the thing I wanted to clarify a little bit here. You are asked by Mr. Mittelstaedt about the numbers of retail stations, but indeed the question really is not only the numbers but the ownership type and kinds of retail station; is that correct?

A Yes. In calculating the concentration at retail, yes.

Q Because there are different kinds of retailers, are there not?

A Yes.

Q And that would be what?

A Well, as the letters indicate, generally lease [171] dealers, open dealers, and each of those tend to be an individual decision-maker. And then company-operated stations, which are a single decision-maker as a group.

Q And that's reflected by the, for example, at the top Chevron and a line directly down to the retail level.

A Yes. In some sense, if we think about Chevron and what's going on at retail, there would be 61 lease dealers each making pricing decisions, there would be six open dealers each making pricing decisions, and then Chevron making the pricing decisions as a single entity for the remaining six company-operated stations.

Q As opposed to just the numbers, why is the mix of retailers significant?

A Because the boxes we put them in are significant because two of those boxes are independent decision-makers, the lessee-dealers and the open dealers, and one of the boxes is a single decision-maker. So, for example, if we shifted – if we switched the 61 and the six for Chevron, making it six lessee-dealers and 61 company-operated stations, we would go from 62 decision-makers to seven decision-makers, even though we'd have the same number of stations in either case.

Q Just to simplify it for me, then, in other words, with respect to what's been referred to earlier as company ops or company-operated stations, then Chevron operates the [172] refinery at the top.

A Yes.

Q Chevron also is a wholesaler.

A Yes.

Q And, if Chevron also owns and operates the stations at the retail level, then that has a significant – that is significant.

A Well, what would happen is we would, in effect, mimic the structure that we have at the wholesale level at the retail level.

Q That's what you meant when you said the number of independent price setters at the retail level then would be affected.

A Yes.

Q Thank you. You know, you were asked about a country club earlier this morning. Do you remember that analogy?

A I do.

Q And you agreed that it was an analogy. I'd like to ask you whether it was a fair analogy or not in this context, the context we're discussing here today.

A Well, I don't think it's – it's not – it's an analogy of a rent control, but its not an analogy of what I believe is the substance and purpose of Act 257. That is, as I think in responding to Mr. Mittelstaedt, I kept emphasizing this is a rent cap as contrasted to a rent [173] control generally in substance. That is, it prevents something from happening that hasn't happened.

So the country club analogy, to me it would be similar to someone owns a country club and they are constrained

from converting it to some other use as long as there are people playing golf on it. And the golfers are concerned that this is going to be made into homes or something, and so they successfully get – or environmentalists are concerned. And there's a bill passed that says you can't increase the monthly dues above some level. That would perhaps cause no change in current rents, but it would prevent whoever owned that country club from taking an action, the result of which – the result of which was to basically make it unprofitable to golf at the country club, and now it can be converted to some other use. To me that would be the real analogy using a country club example.

* * *

[175] Q And you were asked as well, if the oil companies could not charge a market rent, that one alternative that it would have, if it could not recover their lost rent, would be to raise the DTW. Do you recall that?

A I think it was – the phrasing was a physical possibility or something along those lines.

Q Right. That's really the question that I want to ask because I want to try to ask it exactly the way it was asked of you.

I think the way the question was asked and posed to you was is there anything to stop Chevron from physically increasing the DTW – that is, the wholesale price of gasoline – if the rent is capped? And there was, I think, very careful selection of the word "physically." Do you recall that question?

[176] A Yes.

Q What about economically?

A It would serve – it would serve the oil companies' goal under the hypothesis of this question of increasing the amounts collected from the dealers to increase the DTW in lieu of a rent increase only if that meant they could make profit by increasing that DTW price. And, in fact, if an oil company – I mean I believe that oil companies' behavior is best explained by assuming they take actions to maximize the value of their assets or more simply just to maximize their profits. So the economic constraint is that an oil company in setting its DTW prices will have taken account of how the market reacts, how its competitors react, supply and demand conditions, and it will be setting a price that it believes is the price that does the best for the company, that makes it the most money. And, therefore, the economic constraint on it, yes, it could certainly raise the price, charge the dealers. If it does it, it's going to sell less gasoline, and the issue is would it make more money. Well, if it would have made more money raising the price, it would have raised the price.

So the economic constraint is it wouldn't do it because it wouldn't be profitable. So, yes, it could physically do it, but it would not do it.

* * *

[182] Q I'm not talking about the articles. I'm talking about standard economic theory that an oil company has less incentive to invest in lessee-dealer stations if the rent's controlled.

A Yes. I do not dispute that today. I agree with that – I not only agreed at my deposition, I agree with it today. The directional effect is certainly in that direction.

* * *

[185] But, if the oil companies in fact are receiving, as rent, less than what it [186] costs to build and maintain the stations, it could have raised the DTW or the wholesale price of gasoline before Act 257; correct?

A Yes.

Q But it did not, did it.

A No.

Q Why not?

A I presume the answer is because it thought that the price it was charging, given the competitive situations in the marketplace, was the best price that it could charge.

Q The optimal price for DTW or the wholesale price of gasoline that could be charged in the marketplace at any given time.

A Yes.

MR. KOSHIBA: Thank you.

FURTHER RECROSS EXAMINATION

BY MR. MITTELSTAEDT:

Q In the stipulation of facts, number 23 says, "In the aggregate Chevron has not within the last 20 years recovered its expenses relating to dealer stations, ground lease rents, real property taxes, ordinary maintenance and depreciation in Hawai'i or elsewhere in the United States from dealer station rents."

You don't dispute that, do you?

A No, I do not dispute that. I'm just looking for the [187] stipulation I was referring to, which is talking about its overall recovery at its stations.

Q Do you want to find that?

A Sure. Just give me a second here.

A Stipulation 21, I think, implies that.

Q Okay. And 21 says that, "Including the earnings from gasoline – and you agree they need to be included.

A Yes.

Q "Chevron has earned in the past a return that satisfies constitutional standards on investment."

A And anticipates it will earn in the future at levels allowed by Act 257.

Q So you were asked questions about, if Chevron's rent is less than needed to recover its expenses, why doesn't it increase the gasoline price. And isn't it your view that the gasoline price is what it is –

A Yes.

Q – in part because it does include rent. In other words, it includes some portion to help offset the reduction or the fact that the rent doesn't cover expenses.

A Well, I don't think the "because" is proper. It's not what it is because of that, but it is what it is because Chevron in my opinion is setting the price that Chevron thinks is the most profitable price to set, and it turns out that that price is sufficient to cover all its [188] expenses.

Q But, as you look at it, Chevron gets rent from dealers that's insufficient to cover expenses, and it charges gasoline price that helps make up for the lower, relatively speaking, rent.

A I could almost say – go the other way. I could say, well, it charges low rent so it gets people to run these stations, and then it makes a lot of money selling them gasoline. But it's really artificial to separate them in the context of assessing the profitability of the stations.

Q Because, when Chevron sets one or the other or both, it looks at the overall profitability; correct?

A Yes.

Q And you have testified in other cases that the DTW includes rent, in quotes, in that it helps offset the lower than market rents that Chevron charges.

A No. I mean I have testified that it includes rent but not in the sense you said. I've testified it includes rent because it is a charge made – it requires direct supply. The dealer can get the gas cheaper. They're forced to buy the cleaning surfaces in the apartment context from the landlord at a price hi[illegible]her than otherwise available to them, and in that sense it's a charge for the right to occupy the real estate, i.e., economically, that's what we mean by rent.

[189] Q Whether you call it rent or DTW, it all is just money and it adds up to what Chevron thinks the optimal overall price to the dealer is. In my example before, a dollar four; correct?

A It adds up to, yes, the best Chevron can do in dealing with its dealers.

Q Now, if Chevron is required to reduce one component or another, does that change Chevron's view of the optimal amount of money it can get from a dealer or it wants to get from a dealer?

A Yes, it does. It reduces it. It wants to get – it doesn't want to get a hundred and four. It wants to get a million. It wants to get as much as it can. It's able to get a dollar four, and we say you're not able to get a dollar four anymore because we're not going to allow you to charge the old rent. It now can't get a dollar four anymore. So the new optimal is something different: a dollar two.

Q The person within Chevron who says, "All I know is the market let's me get a dollar four from the dealer," that person who doesn't care about whether it's rent or gasoline may still think to himself I want to get a dollar four.

A He may. He won't have a job real long, but he may.

Q Well, if an oil company has a choice of losing the two cents a gallon on rent and not recouping it at all or the [190] other choice is to try and recoup some of it in gasoline, even if the volume's going to decrease somewhat, a person might decide it's better to try and recoup some of it than to lose the two cents a gallon.

A But to say –

Q Could you just answer that. A person could reasonably say that.

A No, he couldn't reasonably say that because to say that says that I would have made more money selling gasoline at a higher price than I was currently charging. And why wouldn't they do that?

Q Because the rent they were charging was the four cents and it was the total package that the dealer was looking at or the market was looking at. But let me ask you this. If you're right on that point, then Chevron bears the full burden of the rent cap or the rent control.

A Yes.

Q And that in turn leads to a disincentive to invest in lessee-dealer stations; correct?

A Yes.

* * *

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF HAWAII

CHEVRON U S.A., INC.	)	CV 97-00933 SOM
Plaintiff,	)	Honolulu, Hawaii
vs.	)	March 25, 2002
	)	9:45 A.M.
BENJAMIN CAYETANO, et al.,	)	Further Hearing
Defendants.	)	

TRANSCRIPT OF NON-JURY TRIAL PROCEEDINGS
BEFORE THE HONORABLE SUSAN OKI MOLLWAY
UNITED STATES DISTRICT JUDGE

* * *

[6] THE WITNESS: Basically, because of the law of demand. When a DTW goes up, the dealers have the incentive to raise the retail price. And, when they raise the retail price, some of their customers will either buy less gasoline or actually leave and go to other gas stations where they buy their gasoline. And so the law of demand puts an upper limit on how much the oil companies can recoup by simply raising the wholesale price.

* * *

[8] THE COURT: Then why wouldn't Chevron raise the wholesale price for those stations to completely offset the rent reduction?

THE WITNESS: Well, they would certainly try. And your question – the reason – they would try to raise the wholesale price to recoup as much of the lost rent as they could, and the law of demand operating at each of those individual stations, however, is going to limit the

total amount they're able to recoup. In other words, at the stations where they raise the price those stations will have a reduction in the volume of gasoline they sell if the dealer raises his retail prices, which logically he would.

THE COURT: Then, if the offset is not total, mightn't consumers in deed benefit from Act 257 because, if the increase in the wholesale price is less than the decrease in the rent, then the lessee dealer's overall cost would go down.

THE WITNESS: No, no. The dealer's overall revenues are going to fall because he's going to be selling less gasoline. It's just that – here's another way to say it. At the individual stations that are affected there's going to be less revenue generated in total from gasoline sales because they're going to lose some customers. And so, even if the oil company doesn't recover all of the rent reduction, that does not mean the dealer is going to [9] benefit because the whole revenue stream is smaller. In fact, in all likelihood both the dealer would lose and the oil company would lose. They're both going – because they've optimized already the combination of rent and wholesale prices that they've chosen. So any deviation from that optimization is going to mean a smaller pie for the dealer and the oil company to divide among themselves.

THE COURT: I'm sure I'm missing something here, but, if the rent goes down, then can't the money that the dealer saves by paying lower rent go toward paying the higher price of gasoline that you've posited so that he would not have to reduce the volume of gasoline that he buys?

THE WITNESS: No. Yeah, you are missing something. And, unfortunately, it's a fairly subtle point,

but, interestingly enough, it's one in which both Dr. Leffler and I agree upon.

And it's the difference in the treatment of rent as what we call a fixed cost and the DTW, which is what we call a variable cost. The reduction in rent by itself – let's suppose the oil companies do not raise their DTW for a second and they just lower the rent to the dealer. There is no reason in our economic theory to believe that the retail prices would fall. That is, the dealer would just pocket the difference. Okay?

[10] THE COURT: Why is that?

THE WITNESS: Why is that?

THE COURT: Why do you say that?

THE WITNESS: Why do I say that.

THE COURT: I know that was in the argument that Chevron or somebody submitted, but I didn't remember any opinion on that during trial.

THE WITNESS: It's actually an opinion shared by Dr. Leffler and myself and all economics text books. And that is that a fixed commitment to pay dollars each month in the form of rent does not affect the decision on how much gasoline to sell or what price to charge at the retail pump. But, when the wholesale price goes up, then the incentive for the dealer to reduce his volume in order to save some of those variable costs will lead him to raise the retail price.

* * *

[11] Q The question is just this. Dr. Umbeck, at page 2 of the state's post-trial brief they say that, "The purpose

of the rent cap is not to directly pass rental savings from the dealer to the consumer. Both economists agree that, as a matter of economic principle, this will not happen." And then they say, "If the dealer has more money in his pocket, it is not expected that he will hand it to the consumer in the form of lower prices."

And my question is to the extent the dealer has [12] more money in his pocket because his rent has been lowered do you agree with that statement? That he is not expected to hand it to the consumer in the form of lower prices?

A Yes. That's basically what I've been saying. When the oil companies by under this rule are required to lower their rent, it just puts money in the dealer's hand. And there's no reason for him to pass that on in the form of lower prices to the retail customer.

However, when the DTW is raised, then he has an incentive to raise his retail price, and that's where you get the volume effect, and that's why the size of the total pie divided by the oil company and the dealer will be smaller. And they both actually are worse off as a result of the change in the mix of rent and DTW.

* * *

[13] Q Dr. Leffler, I understood Dr. Umbeck to say that the law of demand puts an upper limit on how high the DTW price increase could go. Did you generally understand him to be suggesting that there is a limit to the law of demand?

A It's not – it's not that there's a limit. In fact, rather that the law of demand constrains what the best price is. And that has been operative with or without the Act 257

so that my disagreement with Dr. Umbeck is the whole notion that the reaction to a reduction in rent by the oil companies will be an attempt, in quotes, to recoup the amount they lost. If the oil companies could make more money through the pricing of gasoline, they will do that. They will do that whether they can charge lots of rent or no rent. That is, they maximize the profit they can earn [14] from the sale of gasoline.

And so in no sense at all are they setting those prices to recoup anything, and the fact that you change the amount they collected for rent doesn't change at all their pricing incentive with respect to gasoline. So the law of demand is what determined the original price of gasoline. It is still as operative independent of the implementation of Act 257. So that in that regard is my disagreement.

* * *

[15] Q Dr. Umbeck, do you agree with Dr. Leffler's answer about there will be no effect on the DTW price from rent control?

A No. Absolutely not. And the reason is that the DTW is optimized but always subject to the rent that's currently being charged. In other words, when you're charging the dealer, let's say, $5,000 a month rent, you can continue to raise the DTW until you reach some optimum where the DTW generates revenue for the oil company plus the rent revenue that's generated that's at a maximum. Now, when you lower the rent, you allow or make it less costly for the oil company to raise the DTW. And so just given again the basic law of demand it's less costly to raise DTW; therefore, you're more likely to raise it.

So I disagree completely with Dr. Leffler on this one basic point. Oil companies do optimize their DTW, but, when you change the rent, you change the optimization solution, and the DTW will indeed rise to offset partially the added – the loss of revenue from the rent control.

* * *

UNITED STATES DISTRICT COURT

DISTRICT OF HAWAII

CHEVRON U.S.A., INC.

Plaintiff(s),

V.

BENJAMIN J. CAYETANO, et al

Defendant(s).

JUDGMENT IN A CIVIL CASE

Case: CIVIL 97-00933 SOM

FILED IN THE
UNITED STATES DISTRICT COURT
DISTRICT OF HAWAII

March 29, 2002

At 4 o'clock and 00 min p.m.
WALTER A.Y.H. CHINN, CLERK

[ ] **Jury Verdict.** This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

[✓] **Decision by Court.** This action came for consideration before the Court. The issues have been considered and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that Judgment is entered in favor of Chevron pursuant to "Findings of Fact, Conclusions of Law, and Order" filed on March 29, 2002.

cc: all counsel

March 29, 2002
Date

WALTER A.Y.H. CHINN
Clerk

/s/ Barbara Yamada
(By) Deputy Clerk